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E.F. HUTTON MAIL AND WIRE FRAUD CASE

X195

HEARINGS

ORIGINAL

BEFORE THE

SUBCOMMITTEE ON CRIME

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

FIRST SESSION

ON

E.F. HUTTON MAIL AND WIRE FRAUD CASE

OCTOBER 3, 31, DECEMBER 6 AND 11, 1985

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THE E.F. HUTTON MAIL AND WIRE FRAUD CASE

WEDNESDAY, OCTOBER 3, 1985

House of Representatives,
Subcommittee on Crime,
Committee on the Judiciary,
Washington, DC.

The subcommittee met at 9:40 a.m., room 2237, Rayburn House Office Building, Hon. William J. Hughes (chairman of the subcommittee) presiding.

Present: Representatives Hughes, McCollum, Shaw, Gekas, Lungren, Mazzoli, Morrison, and Staggers.

Staff present: Hayden W. Gregory, counsel; Virginia E. Sloan, assistant counsel; Edward O'Connell, assistant counsel; Charlene Vanlier Heydinger, associate counsel; Fred Stuckwisch, GAO consultant; Theresa Bourgeois, staff assistant; Phyllis N. Henderson, clerk; Joanne Royce, staff aide; and Brenda Lang, staff aide.

Mr. Hughes. The Subcommittee on Crime will come to order.

The Chair has received a request to cover this hearing in whole or in part by television broadcast, radio broadcast, still photography or by other similar methods. In accordance with committee rule 5(a), permission will be granted, unless there is objection. Is there objection?

[No response.]

Mr. Hughes. Hearing none, such coverage is permitted.

Today is the fourth of the Subcommittee on Crime's oversight hearings on the *E.F. Hutton* case. In these hearings, the subcommittee is focusing on two areas of inquiry. First, we are carrying out our oversight responsibility over the Department of Justice to determine whether the Department properly exercised its discretion in entering into the plea bargain with Hutton, and whether the terms of that plea bargain best served the public's interest. In order to do that, the subcommittee must learn as much as possible about what Hutton actually did. Without that knowledge, it will be difficult, if not impossible, for us to fairly judge the actions of the Justice Department. Also, as part of that oversight jurisdiction, the subcommittee's hearings have aired publicly the questions raised about the Hutton prosecution, an important function of congressional oversight. No matter which way we resolve the question of the appropriateness of the Department's action, the public debate of such an important issue as the Department's prosecution of white-collar crime cases has, I believe, been healthy and instructive for all concerned.

Our second area of inquiry is into white-collar crime itself. We want to know what kind of atmosphere exists in corporate boardrooms that causes or encourages this kind of criminal activity, or permits it to happen. Two of our last three hearings have focused on this issue as well, in the testimony of various Hutton employees. We heard from all levels of the Hutton organization, including the chairman of the board and chief executive officer, branch managers and from many levels in between.

Today, our focus shifts from an examination of responsibilities of those within the corporation when the company deviates from legal norms to an examination of the role that one important group of outsiders, the accounting profession, might play in preventing, detecting or correcting such deviations. Accountants have occasion to look into the operations of corporate affairs in a number of ways. Today, we will be examining some of the ways in which the accounting profession was exposed to the Hutton money management system which spawned the illegal activity and how the profession reacted to what it saw or failed to see.

Obviously, an inquiry such as this must include an examination of the work of the public accounting firm serving as Hutton's outside auditor during the period in question. Those auditors, representatives of Arthur Andersen & Co., are here today to explain how they carried out their responsibilities to Hutton and to the public.

Also of interest to us is the role of the public accounting firm Arthur Young & Co. Beginning immediately after Hutton learned it was under investigation by the Department of Justice, and continuing up to the present, the company has engaged Arthur Andersen in a number of consultant engagements relating to the Justice Department's charges. Hutton has strongly implied, both in its representations to the Department of Justice and in its public statements that Arthur Young studied the cash management system in question and found it to be acceptable and reasonable. Today we will explore exactly what Arthur Young studied and what conclusions they really did reach.

Our first witness today will, I believe, set the stage for our later panels from Arthur Andersen and Arthur Young. Prof. Abraham Briloff, the Emanuel Saxe distinguished professor of accountancy at the Bernard M. Baruch College of the City University of New York, has long been a leading spokesperson on the principles and ethics applicable to the accounting profession. He has studied the facts and maintained professional scrutiny over the accounting aspects, and will testify on his conclusions today.

As the U.S. Supreme Court recently noted, by certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. The public watchdog function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.

I look forward to hearing from our panels today and our distinguished guest, Mr. Briloff.

At this time the Chair recognizes the distinguished gentleman from Florida, the ranking Republican on this subcommittee, Mr. McCollum.

Mr. McCOLLUM. Thank you very much, Mr. Chairman.

I, too, am looking forward to the hearings today, because they do give the background that I don't have the experience in, in accounting, so that we can better understand the operations that were going on and perhaps the standards that were used, or perhaps abused.

I am especially pleased we have on our panel the gentleman from Florida, Mr. Shaw, who has some background in this area and perhaps can help the rest of us through what we're going to be hearing today. I am also pleased, from chatting with you, you know, that we only have a couple more hearings on the subject, because I think we have had quite a background in this now and we are at a point, perhaps in the next few weeks, that we can judge what our mission is here in terms of the conclusions. So, I think we've had very fruitful hearings and this one today will lend us some additional background that I, for one, am looking forward to.

Thank you.

Mr. HUGHES. I just want to say to the gentleman that I would expect that we would have perhaps as many as three additional hearings, depending upon evidence. We are still having a great deal of difficulty getting the documents to which the subcommittee is entitled to. Unfortunately, we learn every week that there are other documents that we've identified by date and name that have not been provided to us. When the Bell report came in, we determined that there were documents in there that we were told did not exist, that do exist, that we're just getting. We have not received a great deal of documentation from the Justice Department, and as a result this hearing has gone long beyond what I contemplated would be the case; and we've deferred a lot of other matters, as the gentleman well knows. Money laundering is extremely important, that I'd like to move out of committee. We've gotten bogged down in E.F. Hutton and, unfortunately, as long as we don't get the documentation, the evidence that we feel we're entitled to, we can't conclude these hearings.

I might say that we're going to get what we're entitled to, and we're going to do as best we can to reach conclusions from the evidence that exists. And until we get that evidence from E.F. Hutton and from the Justice Department, we're going to pursue it.

Our first witness this morning is Prof. Abraham J. Briloff, Emanuel Saxe distinguished professor of accountancy at Bernard M. Baruch College, City University of New York. He has been a certified public accountant and engaged in practice for more than two score years. He has a degree of doctor of philosophy from the New York University Graduate School of Business Administration. He has received the honorary degree of doctor of humane letters from the State University of New York at Binghampton. He is the author of 4 books, and far more than 100 articles on various aspects of accounting theory and practice.

Professor Briloff, on behalf of the Subcommittee on Crime, we welcome you.

[Witness sworn.]

Mr. HUGHES. Professor Briloff, we are just delighted to have you here. You have had a most distinguished career and we have your statement, which will be made a part of the record in full. You may proceed as you see fit. Welcome.

TESTIMONY OF ABRAHAM J. BRILOFF, PH.D., CPA, EMANUEL SAXE DISTINGUISHED PROFESSOR OF ACCOUNTANCY, THE BERNARD M. BARUCH COLLEGE, CITY UNIVERSITY OF NEW YORK

Mr. BRILOFF. Thank you, Mr. Chairman.

Mr. Chairman, members of the Subcommittee on Crime of the Committee on the Judiciary of the House of Representatives, again I'm privileged to have been invited to appear as a citizen, to share with a committee of the Congress some deeply felt views, or concerns, regarding certain aspects which bear importantly on the profession to which I have devoted my life and professional career as a practitioner, as a teacher, and as a writer. The detailed substance of my presentation is included, of course, in the prepared statement which I submitted to the committee a week ago. I will, therefore, very briefly state some of the high points of what it is that I'm concerned about, and then be prepared to answer whatever questions the committee or the staff might care to direct to me.

Briefly, by way of prolog, the Hutton situation is, of course, important in terms of the accounting ramifications, per se. But as I have made clear in my presentations, including the abstract of the presentation, I consider it vital, and extremely so, because of the fact that it is an important manifestation of a breakdown in what is generally referred to as corporate governance and accountability. And I believe that it is because of the fact that the public perceives this breakdown in corporate governance and accountability in high places, that this particular critical situation has attracted, and continues to attract, the public interest and the interest of the media; even though 5 months have elapsed since the matter was first disclosed.

And the reason that I believe the public senses it, as I do, very intensely, is that here in the Hutton situation we have, inexorably, concentrations of enormous power in hired hands, namely management. And the critical question is, How will and how do those to whom enormous power has been delegated exercise that power? And it is only through their demonstrating their full and open accountability, through the system of checks and balances which are presumed to prevail within our democratic economy, in our corporate society, that the public could feel protected. And an entity like Hutton has an impact on our economy far beyond just its own balance sheet or income statement, because as an underwriter, a broker, dealer in tax shelters and the like, it literally is involved in the allocation of tens and hundreds of billions of dollars of resources of our economic society.

And just one other point in terms of this prolog. Because of the very beauty and the excitement of the American democracy, there is a fluidity between the public and the private sector. And unless those who, in the private sector, develop a sense of integrity, moral and ethical standards of commitment to what it is that might be the transcendent objectives of their particular responsibility, they cannot move effectively into the public sector and then somehow or other try to develop a new set of standards of morality and ethics. So it is that, to me, this is the very most important aspect.

And then I come, as the Chief Justice noted, to what is the role and the responsibility of the independent auditors, who are, after all, the surrogates in behalf of the total public, to move into the corporate entity, as you indicated, Mr. Chairman, to see what it is that is happening there, and then openly and forthrightly and effectively, with intrepidity, to make known to the total society what it is that's going on. This, again, is part of the presumptive system of checks and balances, or the separation of powers, which is the essential beauty of the constitutional process of the United States.

Proceeding, then, where do I sense Arthur Andersen failed to fulfill their responsibilities as the independent auditor in the E.F. Hutton situation?

I've had read to me, very carefully and cogently, the full text of Judge Bell's report, and I've read those four pages and I've duplicated them in the statement regarding Arthur Andersen's role. Sadly, sadly, Judge Bell was entirely superficial in his presentation and understanding and analysis, and moved too quickly to absolution and dispensation.

Where has Arthur Andersen failed?

At the outset and most importantly, they failed to follow through on what they absolutely saw and understood, as early as 1980, as to what was going on. They questioned counsel, as the committee knows, and counsel somehow or other said, "Go away, we're too busy to respond to you." And the Arthur Andersen memorandum of early March 1980 said, "We're going back to do some homework, to see whether that which the company is doing is legal."

And Judge Bell says, "Well, we now found that what they apparently found there was legal because, somehow or other, the Department of Justice tended to confirm that."

Well, the good judge omitted the fact that between 1980 and 1983 or 1984, 3 or 4 years have elapsed. And while everything might have been reasonably appropriate as of early 1980, Arthur Andersen, having seen this aggressive money management, kiting and crisscrossing and chaining and other aspects, where, when I try to understand precisely what goes on, the eyes begin to glaze because of the fact that the transactions were so complex and convoluted.

They saw what it is that was going on. Should they not have followed up, year, by year, by year, by year, and then said, "Look, maybe what was going on in early 1980 we somehow or other can rationalize; but things have gotten tackier and stickier."

And I am then asking, what did they do, year, after year, after year? Did they turn to counsel once again? Did they turn to their own counsel once again? And I'm looking still for memoranda in their files, because, undoubtedly, having seen the critical situation in 1 year, I must assume that the auditor with any degree of responsibility would have followed through.

Where else do I critically fault Arthur Andersen? And, again, a matter that received a number of pages of consideration by Judge Bell.

Somehow, they talk about Arthur Andersen having spoken to the independent audit committee of the Hutton board of directors. And I will come to the audit committee in a moment, but for the moment let me emphasize the critical import of the independent audit committee in all publicly-owned corporations, to the point where the stock exchange requires such a committee and much has been written about their role and responsibility.

The point I want to come back to with respect to Arthur Andersen and the Bell Report: They indicate that somehow Arthur Andersen talked to the committee from time to time; but, did Arthur Andersen recognize the fact that here was a board of directors comprised of 20 persons in the early year, and then 22 persons in the later year, all but 3—all but 3—were members of the executive echelons of the hierarchy of Hutton? As a result, only the three members who were in the audit committee, about which I will speak presently, were, presumptively, the outside directors.

Given that circumstance, Arthur Andersen should have realized immediately, even if everything else were completely appropriate and proper, that the internal control system of E.F. Hutton is highly contingent, because instead of having a board of directors which somehow or other is engaging in some kind of an important oversight function and responsibility over the corporate management, instead, the two have been merged and collapsed, to all intents and purposes. They should have recognized that there was an important role in the care and feeding of that audit committee, and if they felt that they, somehow or other, had a conflict of interest, and they, Arthur Andersen, did not know how to respond to this audit committee, in view of the fact that Arthur Andersen felt a close kinship or tie with management, then Arthur Andersen had a direct and overt responsibility to say to this independent audit committee, consistent with what it is that Mr. Justice Goldberg said about a dozen years ago or 10 years ago, "You had better get yourself independent counsel and advisers to tell you what it is that you have to do to get through this particular thicket."

Again, all that Arthur Andersen—and I'm not saying should have seen, I'm saying what they did see—would have told them, if they were really independent, really intrepid, that here was a situation that was highly contingent and highly loaded. And as my prepared statement notes, I also fault Arthur Andersen for, somehow or other, permitting an obfuscated paragraph to get into the 1983 form 10-K. Mind you this was after the Justice Department had been probing the corporation for over a year.

In sum, with respect to Arthur Andersen—and, again, I'll answer whatever questions might be put to me along the way in that regard—they failed critically and dismally to fulfill that public watchdog function that the Chief Justice alluded to. They failed to manifest that independence, not only in appearance, but also they failed to manifest the independence in fact from their client, and, therefore, failed to fulfill that which is presumed to prevail and the circumstance that has to prevail for the interest not only of shareholders and creditors, but for the total society to which a corporation like E.F. Hutton relates.

I noted in my prepared text the critical commentaries with respect to the independent audit committee, and I believe I've already alluded to them in important measure, but just one, possibly, slight paragraph. The three are very lovely persons. Dina Merrill is a member of the Hutton family and a very fine person, but without any business acumen. The other two members: a Mr. Cazier, who is a member of the law firm that does some work for Hutton & Co.; and the third member is a professor of law of the Harvard Business School.

Now those two, the lawyer and the professor—and I don't even know which discipline he teaches, and I prefer not to know—should have recognized the fact that they were, somehow or other, let's say, the chickens with a circle of foxes around them, and should have recognized the fact that they were chosen, if not as cat's paws—and I'm sure they didn't want to serve as such for management—to serve the overt independent objectives demanded of an independent audit committee. Therefore, they should have, on their own initiative, have said, "Now, wait a minute"—the lawyer, undoubtedly, read in law reviews, and the professor at Harvard undoubtedly read in the Harvard Business Review, of the important role of the audit committee—"maybe we're not doing our job." And I will not accept the kind of rationalization that we find in the four pages of Judge Bell's report, that somehow they relied on Arthur Andersen and that reliance was misplaced.

With respect to management, there I fault them critically, peculiarly; because this is not management of a steel corporation—spelled s-t-e-e-l—this is not management of a chemical corporation, but, instead, this is a management of a corporation which reviews regularly hundreds and thousands of corporate situations as an incident to its underwriting function and as an incident to its financial analysis of corporations with respect to potential investments or disinvestments or counselling and advising. A corporation like so, with such executives, must be presumed to know what are the highest standards of corporate governance and accountability. They should not have to be dragged into the obvious, which is what Judge Bell is trying to do; instead, corporations like Hutton peculiarly must be at the very leadership of our responsibility. And to prove it, and I'm stating this very positively, from whom does the President of the United States seek to obtain the head of the Securities and Exchange Commission? From a corporation like E.F. Hutton. And why? Because the presumption is that, from such a background, the person would know fully and sensitively what a corporate commitment is about. And I state this positively, consistent with what I stated in the prolog.

Now with respect to Judge Bell's actions, I've commented on them critically in a number of respects, but I want to now single out two that come to mind that are of particular import.

The one is the fact that the judge thought that there was but a de minimus impact on the various banks as an incident to the chaining, and kiting, and other aspects. And he demonstrates this by saying, "Well, look at the very few claims that were being filed here. Surely this therefore must demonstrate the fact that we're making a 'tempest in a teacup' or something like so." What the judge should have noted—and I noted this is in my prepared text, and I can't help but repeat the metaphor—the judge, from his experience on the bench, should know that rape victims are very reluctant to come forth and describe what it is that happened to them. So it is that the judge should have recognized that—even though he does tangentially in a footnote, but he goes back to that de minimus simply import and impact—and, in fact, the good judge should have said that the Department of Justice should not have required the rape victims to come forth with a proof of damages, but instead should have required E.F. Hutton & Co. to determine how much, and over what period of time, they euchred the banks. They must have it in their records. And the judge should have recognized the fact that this statement, that is de minimus, is an absurdity; because the personnel of E.F. Hutton at this high level wouldn't be spending so much time and effort on a convoluted system if it weren't going to pay off handsomely. And he should have read the letters from the Department of Justice about the $250 million kiting that was going on. That does not produce a de minimus impact.

And the other, peculiarly, Judge Bell has to be criticized for, he was the Attorney General when President Carter signed into law the Foreign Corrupt Practices Act of 1977. He therefore knows full well, better than anyone, the direct history and the congressional record regarding that particular enactment. And he very extensively criticizes the control system at Hutton, but then does not come out with the condemnation that I would have expected if he were truly the independent investigator that he is presumed to be as a result of what it is that Hutton said about it.

And, very briefly, the Justice Department—and then I will conclude—just one point, and, again, under the overarching aspect of governance and accountability, the Justice Department, in its statements and letters to the Senate, indicated that, more important than just trying to resolve the Hutton situation, they wanted to send a signal to the financial community that this game won't play any longer.

I'm embarrassed about that, Mr. Chairman and members of the committee. In view of the record made at the time of the plea bargaining, where the U.S. attorney noted the fact that the Federal Reserve, and the Postal Inspectors, and the FDIC and others, had pointed up the illegality of these kinds of actions, I shudder to think that any responsible corporate executive, other than someone who says, "I am willing to be identified as someone of organized crime," would fly in the face of those determinations of illegality. So it is that the signal that the Justice Department sought to send was either a fake signal, or, in view of the bargain that was reached, certainly a most muted signal.

Again, Mr. Chairman and members of the committee, I have sought to put into a relatively brief capsule the important concerns that I have with respect to certain aspects, all subsumed in my mind under the overarching, transcendent, anxious concern regarding how will a major corporate enterprise manifest the kinds of governance and accountability which society needs for the very preservation—and I don't believe I'm stating this over dramatically, Mr. Chairman and members of the committee—which society needs for the preservation of our American economic democracy. Rooted as it is in capitalism and the concentration of enormous resources in major corporations, it's an exorable development, in view of technology and in view of the nature and growth of our corporations; and unless we have the same kind of constitutional protection and constraints regarding the private sector that we assume and worked so effectively over the centuries in the public sector, we will be in jeopardy.

So, again, thank you very much for the invitation to me as, again, a citizen to share these views, and I hope I've made some contribution to your deliberations. And I am now prepared to answer whatever questions the committee or the staffs would like to put to me.

[The complete statement of Mr. Briloff follows:]

Corporate Governance and Accountability:

The E.F. Hutton "Sindrome"

Statement of
Abraham J. Briloff, Ph.D., CPA
Emanuel Saxe Distinguished Professor of Accountancy
The Bernard M. Baruch College, City University of New York

Before the
Subcommittee on Crime
The Committee on the Judiciary
House of Representatives
Washington, D.C.
October 3, 1985

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Mr. Chairman, Members of the Subcommittee on Crime of the U.S. House of Representatives' Committee on the Judiciary, my name is Abraham J. Briloff; my principal occupation at present is that of Emanuel Saxe Distinguished Professor of Accountancy at the Bernard M. Baruch College of the City University of New York. I am indeed privileged to have been invited by your Committee to present my views regarding the problems revolving about E.F. Hutton first discerned by the public in early May 1985.

I. - The Transcendent Theme:

My views are presented herewith under the title theme, "Corporate Governance and Accountability: The E.F. Hutton 'Sindrome.'" As will be evident from my presentation I consider the company's money-management problems to represent but one aspect of what went wrong at E.F. Hutton -- and that unless and until the overarching issues are addressed we will be confronted with more E.F. Huttons, and more attempts to treat symptoms rather than the root causes.

1. A year before the E.F. Hutton saga was exposed for public view, a time when the company still spoke in strident tones -- and the world listened, my article in The Journal of Corporation Law*, entitled "The Corporate Governance and Accountability Malaise: An Accountant's Perspective," began as follows:

> At the outset it should be emphasized that while this essay on the corporate governance and accountability malaise is written from "an accountant's perspective" and, accordingly will describe in some detail the ways in which that profession may be importantly responsible for the condition, it is not intended as a discourse on accountancy, per se. Thus, it will not be especially concerned with the financial statement's "bottom line," ratios of liquidity and the like -- except to the extent that misrepresentations or distortions of those numbers may impact on the nature and conduct of the particular corporation or industries. Of transcendent import, the accountant numbers

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* Published by the University of Iowa School of Law

games will be considered as something of an index of the integrity of the corporate managements and the nexus of professions and institutions which serve the corporate enterprises or are responsible for their regulation and oversight.

Adam Smith and His "Benign Hand"

Two centuries ago, in his Wealth of Nations, Adam Smith wrote of the "benign hand" as something of a deus ex machina. He there contemplated that business entities, all acting collectively in free and open competition in the pursuit of their own respective interests, would allocate resources optimally and, as a consequence, maximize the satisfaction of the population and the wealth of nations. Over the centuries there have been some serious misgivings regarding the "hands" that guides the destinies of mankind. Most certainly the presumption implicit in Adam Smith's thesis, that of free and open competition with full access to all information, has not yet been made operative. Nonetheless, this philosophy is presently alive and kicking in the financial marketplace, under the rubric, the "Efficient Market."

Regardless of whether the guiding hand is deemed to be "more or less benign," it is essential that we recognize that the freedoms subsumed in the capitalistic, democratic philosophy and system of government are predicated on a highly advanced and reasonably effective system of accountability in our business sector, which is essentially our corporate sector.

Proceeding further, inasmuch as this corporate society has evolved into a "Power Without Property" structure, it must be assumed that those to whom the enormous pools of power have been delegated are fulfilling their responsibilities to the total society (which includes shareholders and creditors) on a level of ethical conduct adequate to insure the fulfillment of the corporation's objectives and responsibilities. Nor is it sufficient to presume a mere adequacy of adherence to law; in these ethical relationships and deliberations it must always be postulated that "the law is the floor."

The Corporate Potential for Good or Evil

Let us reflect, however briefly and even superficially, on the nature and extent of the corporate potential for good or evil in the present context. We must be continuously, sometimes painfully, aware not only of the corporation's economic muscle, but also of its social, political, and cultural implications. For example, when we believe the fantasy that a major oil or steel entity is essentially a private enterprise, carrying on its far-flung activities as though it were a corner grocer in a free-enterprise economy, then we put our society, and that of other nations, into serious jeopardy.

> When we consider the total environment in which these corporate entities exist, and to which they relate, we see them as having compelling responsibilities to a broad spectrum of "public," i.e., the consumers of the financial statements and narratives compiled by the attesting accountants. This nexus of publics or consumers includes: management, shareholders, labor, government, customers, and consumers, as well as neighbors in the communities in which the corporation operates. Further, as concern for ecology and the well-being of consumers and posterity intensifies, this responsibility will extend to the total society and environment. And because of the multinational character of our major corporate entities, this responsibility and related accountability must be viewed on a universal canvas.
>
> To help assure the integrity of corporate management and the communications to the world of investors, creditors and others who have a vital stake in the conduct of these corporate enterprises we have, over the past half century at least, institutionalized the independent, external audit function.

2. The foregoing reflected my views regarding corporate governance and accountability generally; when related to a giant financial institution like E.F. Hutton the urgency of my concern is multiplied exponentially. That this is patently true becomes self evident when we recognize that as a major stock and commodity broker and underwriter the entity plays a crucial role in the allocation of scarce resources.* As the custodian for untold billions of dollars of other people's money and securities E.F. Hutton, for example, by its mode of voting the securities under its control, is capable of impacting on the destinies of corporate enterprises at home and abroad.

Further, the enormous resources and concomitant power at its command permit the entity's hierarchy to affect the political process in the United States and it political subdivisions. And in view of the fluidity in our democratic society highly-placed persons in, e.g., E.F. Hutton, may move from the private sector to correspondingly highly-positioned places in government, and vice versa.

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* According to Hutton's form 10-K for 1983 its activities extend to: Investment Services (corporate and government securities, options, commodities), Equity Trading, Block Trading and Arbitrage, Investment Banking, Tax Shelters, Investment Management, Research, Life Insurance, Leasing and Credit.

The point I am making is that given these circumstances it becomes necessary to look at our corporate environment not only in terms of its economic pluses and minuses but, in addition, at the moral, ethical, social, and political ramifications. It is because there was a dismal failure on the part of so many of the sectors at E.F. Hutton & Co. which were presumed to exercise the "checks and balances" required to avoid the corruption of, and by, power, that it is essential that the circumstances which there prevailed are fully understood, and that the discerned perversity be purged. And even as I develop this statement, even with the report from Judge Griffin Bell in hand, I sense with intense regret that the circumstances and underlying critical issues are not yet fully comprehended by persons in important positions of responsibility. Instead, I see a lot of rationalization of past behavior, a lot of finger-pointing around the circle. With the foregoing as prologue, I proceed to my critique of the various sectors which I have identified as critically involved in the E.F. Hutton transgressions, and the subsequent denouement.

II. - Regarding Arthur Andersen & Co.:

I begin this critical analysis by focusing on Hutton's independent auditors, Arthur Andersen & Co. ("AA"). I do so, first, because accountancy and the role of the independent auditors for publicly-owned entities is presumed to be my special area of expertise; and then, too, because it is my view that had AA really fulfilled its responsibilities under the circumstances the money-management excesses would have been "stopped dead" no later than 1980 or 1981.

1. Let us first take note of the way in which the role of the accounting firm is presented in "The E.F. Hutton Report: A Special Investigation Into the Conduct of E.F. Hutton & Company, Inc. That Gave Rise to the Plea of Guilty Entered on May 2, 1985 (the "Bell Report") (pages 96-100):

> Thomas W. Rae was Executive Vice President and General Counsel. His responsibilities as head of the Legal and Compliance Department were vast and included not only supervisory responsibilities for the Legal and Compliance Division and Audit Division, but also other additional administrative responsibilities. Rae has been criticized for failing to provide a legal opinion to Arthur Andersen in 1980 on Hutton's drawdown procedures. Arthur Andersen, the auditors for Hutton, inquired of Rae, the Vice President and General Counsel, as to the legality of the drawdown system, and he declined to give a written opinion as to its legality, contending that it was so obviously legal that no opinion was required. This was accepted by Arthur Andersen, and that drawdown system was continued. It has now been approved by the Department of Justice civil decree over Hutton, but only on the condition that the banks be notified of its use and that the banks agree. [Emphasis supplied.]
>
> The Audit Committee of Hutton Group has indicated that it received comfort during the 1980-82 time period from Hutton's outside auditors, Arthur Andersen & Co. ("Arthur Andersen"), regarding the adequacy of Hutton's system of internal accounting controls. Arthur Andersen and Hutton agree that Arthur Andersen has never delivered to Hutton any report or opinion on the adequancy of Hutton's internal accounting controls relating to Hutton's cash concentration system taken as a whole. Notwithstanding the absence of any formal report or opinion, the Audit Committee suggests that its comfort came from certain memoranda and other opinions delivered by Arthur Andersen and from Arthur Andersen's advice concerning Hutton's efforts to document internal control procedures in response to the Foreign Corrupt Practices Act.
>
> Arthur Andersen acknowledges that it annually issued to the Audit Committee of Hutton Group a memorandum on accounting procedures and internal accounting controls. According to Arthur Andersen, each of those memoranda contained an introduction that stated generally that the study underlying the memoranda was not designed for the purpose of making detailed recommendations and would not necessarily disclose all weaknesses in Hutton's existing systems. In addition, Arthur Andersen indicates that the memoranda arose not in connection with a report on the adequacy of specific internal controls or on an entire internal system, but instead in the context of a determination of the review and evaluation of internal controls

> in the context of an annual audit. The purpose of a review and evaluation of internal controls in that context is solely to assist in the determination of audit scope.
>
> Arthur Andersen also acknowledges that it annually opined as to whether it discovered any material weaknesses in Hutton's system of internal accounting controls. A review of certain of those opinions supplied to us by Hutton indicates that they do not purport to be based on a review of Hutton's internal accounting controls relating to Hutton's cash concentration system taken as a whole. Rather, those opinions are expressly limited on their face to weaknesses in internal accounting controls discovered by Arthur Andersen during its examinations of Hutton required by Rule 17a-5 under the Securities Exchange Act of 1934 and Regulation 1.16 under the Commodity Exchange Act. . . .
>
> Arthur Andersen also has advised us of its role in Hutton's efforts to document internal control procedures in response to the Foreign Corrupt Practices Act. According to Arthur Andersen, its role was limited to several meetings with the Audit Committee of Hutton Group, presentation of a methodology and a specimen report on the documentation of internal controls, conducting a two-day training seminar for selected Hutton employees to train those employees in the proposed methodology for evaluating internal controls, and coordinating with Hutton employees the implementation of the proposed methodology. The documents supplied to us by Hutton regarding certain meetings of the Audit Committee confirm the scope of Arthur Andersen's role in this matter. Hutton's Executive Vice President, Norman Epstein, has advised us that the internal control procedures enacted in response to the Foreign Corrupt Practices Act did not extend to specific controls in the area of cash management.

Regrettably Judge Bell saw fit not to consider all the implications of AA's 1980 request. Thus, the firm's files include the following memorandum:

A. A. & CO.
FORM

INTEROFFICE COMMUNICATION

Files 6

NEW YORK OFFICE

MARCH 7, 1980

MEMORANDUM FOR THE FILES

RE: E.F. HUTTON MONEY MANAGEMENT PROCEDURES

On March 5, 1980, representatives of AA&Co. and E.F. Hutton met to discuss the client's procedures in the area of "money management." Present in attendance were Joel Miller, Louis Lynn, Pat Gallagher, John Tesoro and Ted Chambers of AA&Co. and Thomas Rae, Michael Castellano and Larry Volpe of E.F. Hutton. The meeting was conducted by William Sullivan, Hutton's "Money Mobilizer." The purpose of the meeting was to obtain a greater understanding of the client's cash management procedures, whereby efforts are made by the firm to pay down bank loans and, thus, reduce interest expense. In addition, the meeting was also intended to discuss the company procedure of writing checks even though the balance per books is zero or negative. This is particularly relevant in light of the recent TI Industries lawsuit where that firm was found criminally at fault for writing checks in excess of book and bank balances.

Bill Sullivan explained Hutton's procedure with eleven different banks (client is presently exploring the possibility of using five more banks) where checks are drawn on these banks even though the balance per book would not cover the amount of the checks. Mr. Sullivan pointed out that in each of these banks Hutton has deposited CEA funds which, even though they are legally segregated and cannot be used by the bank to cover shortages in Hutton's "general account", are treated as "offsets" by the banks under a "global approach" which allows Hutton to overdraw its balances. In addition, Hutton has put up as collateral available customer securities @ DTC to "cover" the various banks' uncollected funds. These funds result in deposits made by Hutton via check which have not cleared (normal clearing period is one day).

Similarly, the company also has a "check payable" or "zero balance checking" agreement with the Bank of America for payment to vendors and for issuing dividend payments to customer. Under this agreement, the Company writes checks overdrawing book balances, but maintains a zero or small deposit balance with the bank. This procedure is possible, according to William Sullivan, because the bank, each business day at 1:00 P.M., notifies the Company as to the required federal funds deposit to cover checks clearing the bank that day. The bank does not require any collateral for this particular arrangement.

The client maintains that the key to engaging in such transactions is that Hutton has the "means" to make ultimate payment. In other words, in the normal course of business the settlement of transactions will result in actual

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INTEROFFICE COMMUNICATION

MEMORANDUM FOR THE FILES   -2-   MARCH 7, 1980

RE: E.F. HUTTON MONEY MANAGEMENT PROCEDURES

cash balances being deposited in the banks and, as a result, the balances per bank are rarely, if ever, overdrawn. Mr. Rae stated that the fact that Hutton has these "means" to pay, precludes any possible illegalities in processing these transactions. Mr. Sullivan further pointed out that Hutton has always been "above board" in its dealings with the banks and that the banks are fully aware of the nature of these transactions (i.e., drawing checks on the account even though Hutton's records do not reflect a book cash balance large enough to cover the check at the time it is drawn). He also stated that several banks (Chase Manhattan, for example) have requested Hutton actually increase the scope of these activities.

After the discussion of the procedures employed and their legality, Joel Miller, AA&Co. engagement partner, requested that Tom Rae render a written legal opinion stating that Hutton's activities in this area don't present any potential legal problems. Mr. Rae declined to render such an opinion, stating that the banks are fully cognizant of Hutton's procedures, that this is an accepted banking practice and that there is no question as to the propriety of such transaction, again making reference to the "means of payment" principles. After Tom Rae declined to issue an opinion on this matter, Bill Sullivan offerend to call one of the banks Hutton uses, Morgan Guaranty, and ask them what the banks would do if a company were to issue checks with no book balances (i.e., such as Hutton's segregated commodity balances). Joel Miller then stated that he would discuss the matter with other partners at AA&Co. whose clients include major money center banks to ascertain what the bank's "point of view" is regarding these transactions.

LOUIS T. LYNN
JOHN TESORO

gmb

Alas! Insofar as AA's 1980 request for a legal opinion and brush-off, AA is exculpated by Judge Griffin Bell. But let's hold on -- for me, the "jury is still out" on this issue.

Note the concluding paragraphs of AA's March 7, 1980, memorandum in which the firm had agreed to undertake some "homework." Note that it was going to inquire of its banking partners regarding prevailing practices. Did AA fulfill that assignment? If so, what contemporaneous documents are in its files describing its pursuits, and the results therefrom? If it was to turn out that AA did nothing to verify the glib responses from the Hutton people, then I maintain that the firm has failed to follow through in a most material respect.

But even more grievously, the March 1980, discussion was undoubtedly related to the 1979 audit and the money-management conditions which prevailed at that time. Having taken cognizance of the problem on that earlier audit what probes did AA institute in 1981 regarding the 1980 audit; in 1982 regarding 1981; in 1983 regarding 1982? I presume that when AA was making its rounds for the 1982 audit it was fully informed regarding the probes which were then in process pertaining to the aggressive procedures which had been in vogue over the years; what audit procedures were then introduced? Why was there no reference to the critical problems which were festering?

2. By early 1984 the company was constrained to disclose something in its 1983 form 10-K; and this is what they said, at page 18:

> A Federal Grand Jury in the Middle District of Pennsylvania is conducting an inquiry into certain cash management practices at EFH. The Company understands that the practices under inquiry do not involve or relate to any relationships with EFH's public customers or investment banking clients or any securities, commodities, insurance or other transactions with such persons. While the Company cannot predict what, if any, action will result from such inquiry, it believes that its internal cash management policies are consistent with all applicable laws and regulations and are similiar to the policies of many other public companies.

Surely AA must be charged with full knowledge of that statement in the report filed with the SEC. Did the firm concur in that libeling of "many other public companies"? Can the firm identify any corporation, publicly-owned or otherwise, which evidenced year-end excesses of "Drafts and Checks Payable" over "Cash subject to immediate withdrawal" amounting to $314-, $151- and $404 million for the years 1981, 1982, and 1983 respectively?

3. Turning to the loss of an effective system of internal control (which, as will be discussed presently, Judge Bell amply concedes) we first note the only limited responsibility which AA saw for itself -- a role which the Bell Report appears to accept without challenge. I maintain that only an ostensibly independent auditor determined to be afflicted with myopic tunnel vision would see its role thus restricted in its audit of a major financial institution like E.F. Hutton. As the custodian or fiduciary of tens of billions of dollars of other people's money, a rigid effective system of internal control is the sine qua non of the accountability process. And those of us whose experience and memories go back some fifteen years recall tragically such names as: Francis I. DuPont, Orvis Brothers, Hayden Stone, Dempsey Tegeler, et al., brokerage firms which went "belly up" (as the saying goes on Wall Street) -- all because of a disintegration in their internal control procedures. We recall the panic evidenced in the financial community -- a condition which translated itself into the enactment of the Security Investors Protection Corporation ("SIPC"). Also to be considered presently, before an auditor for an entity like E.F. Hutton can be presumed to have fulfilled its responsibilities, an in-depth, direct probe of the system of internal control should have been undertaken and concluded. In short, I refuse to accept AA's self-exculpatory and self-serving limitations on its role; I refuse to concur in Judge Bell's apparent absolution of AA in this critical respect.

4. But I do not have to indulge in the foregoing presumption to inculpate AA. I maintain that as an incident to its audit of E.F. Hutton's cash activities it undoubtedly found the aggressive overdrafting. Even an accountant on his (or her) initial audit engagement would have observed the extent to which Hutton's checks were being used to create the appearance of legitimate bank balances. While Judge Bell (judging from his report) never heard of kiting, or based on his remarks during the September 5 MacNeil-Lehrer television interview, does not understand its meaning, that phenomenon is considered regularly in our courses in auditing. (Included herein as Attachment 1 are the relevant pages from Auditing - An Integrated Approach by A. Arens and J. Loebbecke; I have selected that text because it was the one cited by Chief Justice Burger in his landmark Arthur Young & Co. opinion, to be considered below.)

Having seen all this I impeach AA for its failure to inform Hutton's audit committee of all that the firm knew (including its 1980 misgivings and their aftermath). And, mind you, I am stating all this independently of the added responsibilities vested in auditors, boards of directors and managements under the Foreign Corrupt Practices Act of 1977 ("FCPA").

5. In sum, AA failed to fulfill the responsibilities vested in the audit of publicly-owned entities. These standards were set forth most vitally by the Chief Justice in the decision of the Supreme Court of the United States in U.S. v. Arthur Young & Co., thus:

> Corporate financial statements are one of the primary sources of information available to guide the decisions of the investing public. In an effort to control the accuracy of the financial data available to investors in the securities markets the Securities and Exchange Commission regulations stipulate that financial reports must be audited by an independent certified public accountant.

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This public watchdog function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.
>
> The SEC requires the filing of audited financial statements thereby encouraging public investment in the nation's industries. It is not enough that financial statements be accurate; the public must also perceive them as being accurate. Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional. [The auditor is not] an advocate for the client. If investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost.*

6. Given the foregoing I find it ironic that the Bell Report included the following among its "Summary of Recommendations": "That Hutton employ its independent accountants to review the adequacy of Hutton's system of internal accounting controls relating to the cash concentration system." Unless the special investigators contemplated a change in auditors I cannot avoid the acerbic remark that this is very much like sending a fox to guard the hen house (or a goat to guard the cabbage patch).

7. AA should have taken very careful note of, and have been especially sensitive to, the condition disclosed by Hutton's 1982 proxy statement. After listing the slate of 20 directors, footnote reference 5 noted that: "All the nominees [excepting the three members of the audit committee] have been executive officers of Hutton or EFH for the past five years."

Most assuredly this should have alerted the accounting firm to the fact that Hutton's board was not so constituted as to permit it to fulfill the responsibilities traditionally vested in the board. Surely AA should have been alert to the fact that while the three members might not be "babes in the woods" they did require very special guidance and counseling so that they could act as a check-rein, when appropriate, over the other seventeen. (One year later the same three were on the audit committee, and they retained the dubious distinction of being outnumbered by the the management group -- which now numbered nineteen.)

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* 104 S. Ct. 1495 (1984)

8. In a more prosaic vein I have the following interrogatory for AA:

a. Should not the initial footnote relating to Hutton's accounting policies have disclosed the company's policies relating to accounting for cash balances (and more particularly the exotic item "Drafts and Checks Payable")?

b. In view of the magnitude of the aforementioned payable, representing as it does, Hutton's borrowings from its banks, should there not have been a footnote disclosing in detail the composition of that liability and any funds and/or other collateral held by the banks to secure repayment?

c. Given the enormity (in absolute and relative terms) in the amounts of such Drafts and Checks Payable were there any balances of cash really available for immediate withdrawal? If so, how was such amount determined?

III - Regarding Hutton's Audit Committee:

And so, as the Bell Report informed us, Hutton's Independent Audit Committee relied on AA to guide it in the fulfillment of its responsibilities for insuring an effective system of internal control -- and as it turned out, that reliance was grossly unwarranted. I, of course, empathize with the three persons who comprised the committee; nonetheless, they should not be blithely absolved. After all, having assumed a position on Hutton's board of directors, and especially its audit committee, the members must not be permitted to avoid their responsibility by asserting that they were led down the primrose path by the company's independent auditors -- no matter how prestigious that firm might be.

According to Hutton's proxy material, during the years from 1981 the committee was comprised of: Professor Warren A. Law, Edward C. Cazier, Jr., Esq., and Ms. Medenia H. Robertson (Dina Merrill).

The March 1982, proxy material provided the following additional information regarding these three directors:

- Mr. Cazier: Partner, Hahn Cazier & Leff, attorneys. The law firm received fees from Hutton aggregating $132,713 during 1981.
- Professor Law: Professor, Graduate School of Business Administration, Harvard University, director, Crompton & Knowles, Dynatech Corp., Security Capital Corp.
- Ms. Merrill: Actress and private investor.

I will not assert that their credentials necessarily gave them special expertise regarding internal control, compliance with the FCPA, the esoteric aspects of money management and the like. Nonetheless, each of these persons is someone with sophistication and responsibility; as such, they are presumed to know when they have assumed major responsibilities for which they themselves may not possess the appropriate expertise. Under such circumstances I expect persons of sophistication and responsibility to insist on obtaining counsel from a consortium of independent advisors.

Nor is that which I am here suggesting being presented ad hoc; instead, included herewith as Attachment 2 are pages 247 through 253 from my The Truth About Corporate Accounting (Harper & Row, 1981). I am not suggesting that these pages reflect the ultimate answer in this regard; it is likely that AA has, over the years, published monographs dealing with the role and responsibilities of the audit committee. I know that the Conference Board has published such guides.

In short, the audit committee may not have obtained the counsel it required to help it fulfill its responsibilities; but then, I submit, the fault is with them.

IV. - Regarding Hutton's Board of Directors and Management:

I have merged these two segments of Hutton's organization, since a study of the composition of the board discloses that while it may be distinguishable from management, there is hardly a difference. In fact, if I revert to my criticisms of AA, the very fact that the board is so heavily weighted with management personnel in and of itself reflects invidiously on the internal control environment at the corporation.

But turning directly to this critique:

1. When, in its halcyon days, E.F. Hutton spoke to the world it spoke with a single vibrant voice. As it turns out, the circumstances that prevailed at the institution were drastically at variance from the appearances. Instead of a well-integrated team we find something of a Byzantine establishment -- each major sector was isolated in its own cell without any critical dialogue among the operatives. And when the "chips were down" and "push came to shove" everyone in a position of responsibility pointed to someone else -- and ran for cover.

2. This criticism is related to the foregoing. Thus, one has the right to expect that an entity of Hutton's size, stature and position in the totality of our economic democracy, would have demonstrated leadership in the development of an optimum corporate structure. Instead, as the Bell Report

makes abundantly clear, Hutton has to be "dragged" into an organizational structure responsive to the entity's position as the guardian of tens of billions of dollars of other people's money and property.

Be it remembered that the board of directors of an enterprise like Hutton should not be seen as management's "cat's paw"; instead, it must play a vital role in behalf of shareholders, creditors and the "outside world" generally. And it should not have taken Judge Bell to teach the board and management this basic lesson.

3. Alluding once again to the 1983 10-K disclosure regarding the probe by the grand jury, it is abundantly clear that even as late as early 1984 management did not face up to the moral and ethical implications of its perverse conduct. Instead, we recognize the hubris implicit in the "when Hutton speaks" pitch.

4. And even after pleading guilty to the 2000-count information based on mail and wire fraud, Hutton's management endeavored to absolve itself in an important respect. Thus, from the remarks of Hutton's Board Chairman at the company's May 17 meeting:

> First and foremost, the practices in question did not involve customer or client funds. Our most fundamental commitment as a company is to our customers and clients, and that commitment has not in any way been breached. The injured parties were some of the approximately 400 commercial banks where the Company maintained checking accounts over the 1980-1982 period.

And from the company's May 2 press release:

> The Company and its auditors did not detect these deviations because the Company's internal controls were geared towards assuring compliance with the numerous state, federal, and internal regulations that safeguard customer accounts. Those controls have always worked and continue to work well. In retrospect, however, the Company could and should have kept a tighter rein on its internal banking practices to keep them from crossing the dividing line between aggressive and improper.

I maintain that, given the facts here involved, these statements are unwarranted. Thus:

a. As is evident from the AA memorandum (which came to light after the May releases) AA was aware of the festering problem.

b. Inasmuch as the accounts subject to the chaining and overdrafting were the same accounts in which customers' balances were deposited, the illegal conduct related to customer funds.

c. As noted by the AA memorandum, the subject banks may have been made secure by the deposit of "available customer securities."

d. By its overdrafting, chaining and kiting procedures Hutton was obtaining substantial amounts of loans from banks without demonstrating credit worthiness for such loans. To the extent such borrowings may have exceeded prudent lending limits Hutton's customers (and/or the SIPC) would appear to have been at risk.

V - Regarding Judge Griffin Bell:

I now proceed to take issue with a number of aspects of the Report promulgated under Judge Griffin Bell's aegis. To the extent the report represents an advocate's brief in behalf of a client, given the prevailing facts and circumstances, the report is a tour de force. As a report from an investigator, presumed to pursue the truth no matter where it might lie, and then to relate the findings and recommendations without let or hindrance, no matter where "the chips might fall" I have some serious misgivings. So it is that while the Report is not a "whitewash," it is nonetheless, a "greywash." By way of fleshing out this impeachment:

1. Under the caption "Bank Restitution Program" the Report cites the relatively few claims which were filed by the euchred banks, and the

relatively tiny sums claimed, and concludes: "This is compelling evidence that injury to banks has been greatly overstated."

This felicitous conclusion is carefully hedged by the following critical footnote:

> We believe that a few banks are reluctant to assert claims in part because of the time and expense required to review or recreate records of transactions that occurred five years ago and in part because of a fear of possible adverse local or national publicity if the bank discovered that it had a claim against Hutton.

Most certainly Judge Bell's experiences on the bench and otherwise must have informed him that rape victims only rarely disclose the tragic events -- instead, they prefer to put it out of mind. So it is, as the footnote implies, the victimized banks preferred to keep their "shame" to themselves.

But this raises an even more vital issue, to wit: Should not Hutton's plea bargain have called for Hutton to determine which banks "had been had" by its chaining, criss-crossing, over-drafting, etc. schemes, and thereupon determined the means of restitution? Or if that procedure is not feasible, should not Hutton have been constrained to determine the amount of interest earned (or expense avoided) by its illicit practices and provided a fund in that amount (plus compound interest)?

Further in this regard, Judge Bell should have recognized that the amounts in issue were not *de minimis*. Logical reasoning should have led him to conclude otherwise. Thus:

a. Had the benefits been negligible the consequences from the improper conduct would not have called for the high praise from the Hutton hierarchy.

b. Given the levels of sophistication of those involved in the schemes they would not have involved themselves in the devious procedures if the cost-benefit relationships were not dramatically favorable.

c. Judge Bell's conclusion is seriously in conflict with the following assertion of the Justice Department Summary of the Investigation and Prosecution: "By overdrafting as much as $250 million per day from its depository accounts, and perpetuating its overdrafts on successive days, Hutton both avoided the necessity to borrow extensive amounts of working capital and earned interest income on surplus funds."

2. Judge Bell's Section IX, "Standards for Corporate Governance," is especially relevant to my presentation this morning; and there is no person better able than Judge Bell to guide us in this important probe. Be it remembered that he was President Carter's Attorney General at the very moment in history when the President signed into law the Foreign Corrupt Practices Act of 1977 ("FCPA") which, as the President noted, was expected to put an end to "ethically repugnant and competitively unnecessary" conduct.

The Bell Report proceeds to consider the broad sweep of the enactment as discerned from speeches of Harold Williams, the SEC Chairman under President Carter, and otherwise. Because of its vital role in this context I have included the entire Section IX as Attachment 3 to this statement; correspondingly, I have included as Attachment 4 pages 190 through 192 from my The Truth About Corporate Accounting wherein I also traced the history of the FCPA enactment.

Given the forthright critical and categorically adverse commentaries by Judge Bell regarding Hutton's internal control system I might have expected him to pass judgment on the corporation insofar as its FCPA compliance was concerned. I might have expected that such an intrepid investigator would have declared flatly that independently of the firm's culpability under the mail and wire fraud statutes, it had clearly and overtly violated the FCPA -- and then to identify those persons who should, under the act, bear the onus of such a charge.

Granted persons in highly-placed executive positions in government or business cannot know all that is going on in the parishes or even in the principal base of operation; they have a right to rely on the effectiveness of the "checks and balances" system which had been put in place -- but then these highly-placed persons are charged with making certain that there is an effective independent investigative and oversight process. Instead, the system which was implemented at Hutton appears to have been designed to produce deniability -- in any event that is how the system evolved.

Now, then, I submit that the system did not come into being parthenogenetically, like the goddess Athena from the forehead of Zeus. Judge Bell should have identified those who created the system, or at least corrupted it, and held them up as those who, at the least aided and abetted the FCPA violations.

(As an aside, I hope the incumbent Chairman of the Securities and Exchange Commission is carefully monitoring the saga of the Hutton fiasco with a view towards determining whether the covenant given the Congress by Chairman Roderick Hills*, sought to be implemented by the SEC in its 1979 proposal, should now be reactivited.)

VI - Regarding the U.S. Department of Justice

There are a number of facets of the Hutton criminal proceedings which raised serious questions; I will limit my commentary to but one such misgiving which appears to be especially relevant to this corporate governance and accountability critique.

At page 20 of the Department's Summary of the E.F. Hutton Investigation and Prosecution we read:

---

* See p. 191 of my Truth About Corporate Accounting included herein as part of Attachment 4.

> A major objective of the prosecution was not only to bring an immediate halt to Hutton's money management abuses, but also to make the case a landmark that would establish specific standards of practices for money management. This second objective was linked to our assessment that Hutton's practices, if replicated by financially precarious companies, had tremendous potential for harming banks, particularly the smaller, more vulnerable banks.

Assistant Attorney General Stephen S. Trott made the same point in his May 29 letter to Senator John Glenn (at page 2):

> In addition to looking after the interests of the individual victims, it is also one of the important priorities of the Department of Justice to protect the banking industry itself from fraudulent schemes and predatory money-management practices. Cash concentration systems, as you can see from the article I am enclosing from the American Banker, have become a science. Professionals working in that specialty have associations which sponsor conferences, exchange information, and publish articles. The activities of this highly technical industry have a definite impact on our nation's banks and financial institutions of which few people are aware. The Federal Reserve has been highly critical of "float-playing games," of which Hutton's was an extreme example, and we are in agreement with that concern. Hutton's practices, if replicated by financially precarious companies, have tremendous potential for harming banks, particularly the smaller, more vulnerable ones. The clear message sent to money managers around the country by this conviction coupled with the injunction that covers conduct that we were unable to include in our charging document achieved important multiple objectives in a single decisive stroke. It left no doubt that these kinds of abuses are criminal and will be prosecuted.

I find these assertions incomprehensible, or to the extent that they are comprehensible, incredible. What the Attorney General is implying is that American business is in the control of persons who knowingly and willfully are committed to flouting the law; only a hardened, confirmed cynic who has given up on our American Capitalistic Democracy could seriously hold such a view. The Attorney General is undoubtedly intimately familiar with the transcript of the proceedings in the U.S. District Court for the Middle District of Pennsylvania in the matter of United States of America v. E.F. Hutton & Co., Inc. At pages 56-57 thereof we have the following colloquy between Judge Nealon and U.S. Attorney Murray:

> THE COURT: May I ask, what other agencies, governmental agencies may have been affected, and may have been consulted?
>
> MR. MURRAY: Your Honor, the Federal Reserve Bank of New York was affected and did a study, and a report, along with the New York State Banking Department, which determined that this activity was of a fraudulent nature and was for the purpose of creating float.
>
> The FDIC, Federal Deposit Insurance Corporation also conducted an investigation and reached similar conclusions. Various non-governmental agencies, various banking institutions also did internal audits and determined that this activity of chaining and excessive drawdowns represented activity that was not a part of legitimate business practices and did not represent their expectations, did not meet their expectations in the handling of this account.
>
> A team of, what we believe to be experts of the United States Postal Inspection Services, accountants, several accountants, reviewed the activity and reached that conclusion. So it's been reviewed by many, many persons, your Honor.
>
> THE COURT: OK.
>
> * * * * *
>
> MR. MURRAY: The Federal Reserve has, however, in its policies and in its report of April of 1982, viewed these policies as being unlawful, or these practices, sorry, your Honor, as being unlawful.

I maintain that the vast majority of American business executives knew, and know, intuitively that kiting by any name or means is improper and therefore to be avoided; they did not and do not need yet another signal.

And for those few who require the signal Mr. Trott alluded to, the one provided by the bargained arrangement with Hutton is anything but clear -- and is made even more muted by the Bell Report.

In my view the Department of Justice would have sounded the tocsin far more loudly and clearly if it permitted the Grand Jury to vote some indictments against particular individuals who were especially responsible for the perversity perpetrated at E.F. Hutton. True, the Department would have been constrained to allocate important resources to what, at best, would be a most disagreeable prosecution. But only then would society recognize that our Scales of Justice are balanced equally for the affluent and powerful as for those less-felicitously situated.

VII - The Nation's Intuition:

Mr. Chairman, Members of the Subcommittee on Crime of the House of Representatives' Committee on the Judiciary, the E.F. Hutton saga has captured and retained the interest of the citizenry and media of our Nation. It is my belief that this important interest is attributable only in part to the criminal conduct, per se, or the relatively benign response from the Department of Justice.

Instead, as I see it, the intensity of interest is rooted in the fact that our citizenry intuitively senses the transcendent implications and ramifications of the particular circumstances. It is this transcendent pervasive theme which I have subsumed in the title theme for my presentation this morning -- Corporate Governance and Accountability: The E.F. Hutton "Sindrome."

Again, I very much appreciate the opportunity afforded to me as a citizen to share my experiences and views with you, and hope that I have thereby contributed to your inquiry into the E.F. Hutton matter, and related issues. I would be pleased to respond to any questions which you or your staffs might have for me.

Thank you.

N.B. The accompanying pages were photocopied from a volume borrowed from the Library of the American Institute of CPAs. Any interlineations, underscoring or other notations were made by previous borrowers and have no relevance to this presentation.

ATTACHMENT 1

Auditing:
An
Integrated Approach

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Michigan State University

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PRENTICE-HALL, INC., Englewood Cliffs, New Jersey

larly, all reconciling items in the December 31 bank reconciliation should be items from the November bank reconciliation and December's journals that have not yet cleared the bank.

In addition to the tests just described, the auditor must also carry out procedures subsequent to the end of the year with the use of the bank cutoff statement. These tests would be performed in the same manner as previously discussed.

Proofs of Cash. Auditors frequently prepare a proof of cash when the client's internal controls over cash are not considered adequate. A proof of cash includes the following:

1. A reconciliation of the balance on the bank statement with the general ledger balance at the beginning of the proof-of-cash period.
2. A reconciliation of cash receipts deposited with the cash receipts journal for a period of time.
3. A reconciliation of canceled checks clearing the bank with the cash disbursements journal for a period of time.
4. A reconciliation of the balance on the bank statement with the general ledger balance at the end of the proof-of-cash period.

A proof of cash of this nature is commonly referred to as a four-column proof of cash—one column is used for each of the above types of information. A proof of cash can be performed for one or more interim months, the entire year, or the last month of the year. Figure 18-4 depicts a four-column proof of cash for an interim month.

The auditor uses a proof of cash to determine the following:

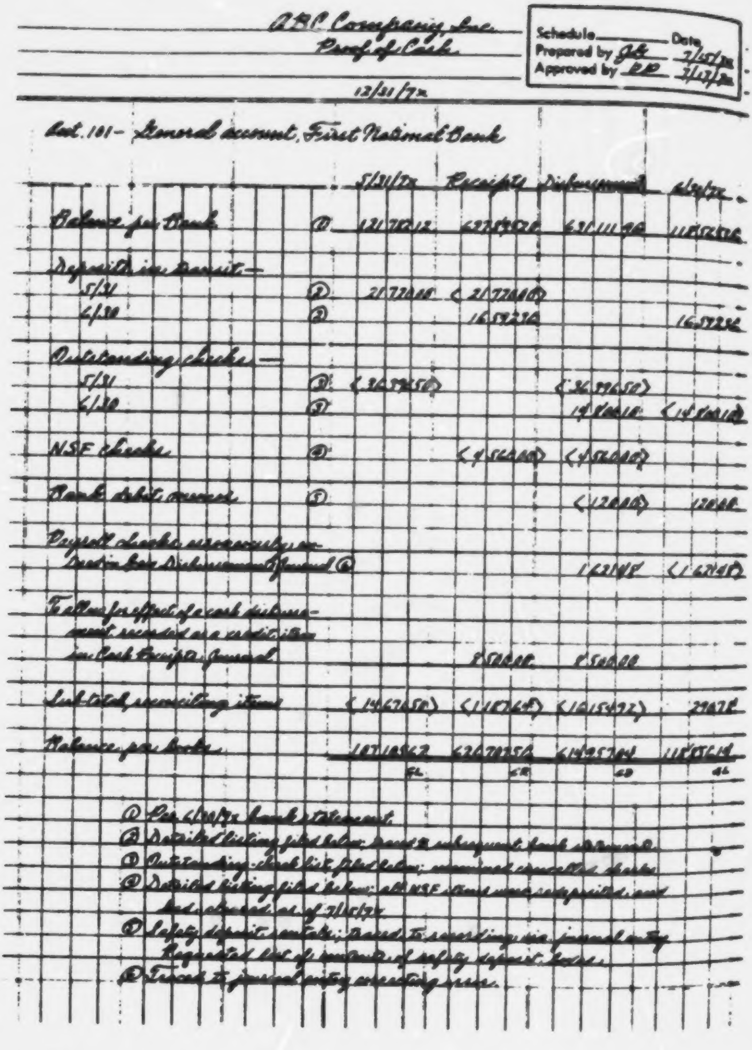
1. Whether all recorded cash receipts were deposited.
2. Whether all deposits in the bank were recorded in the accounting records.
3. Whether all recorded cash disbursements were paid by the bank.
4. Whether all amounts that were paid by the bank were recorded.

When the auditor does a proof of cash, he is combining tests of transactions and direct tests of balances. For example, the proof of the cash receipts is a test of recorded transactions, whereas the bank reconciliation is a test of the balance in cash at a point in time. The proof of cash is an excellent method of comparing recorded cash receipts and disbursements with the bank account and with the bank reconciliation. On the other hand, the auditor must recognize that the proof of cash disbursements is not useful for discovering checks written for an improper amount, invalid checks, or other errors where the dollar amount appearing on the cash disbursements records is incorrect. Similarly, the proof of cash receipts is not useful for uncovering the theft of cash receipts or the recording and deposit of an improper amount of cash.

Tests for Kiting. Embezzlers occasionally cover a defalcation of cash by a practice known as *kiting:* transferring money from one bank to another and improperly recording the transaction. Near the balance sheet

FIGURE 13-4

PROOF OF CASH



ABC Company Inc.
Proof of Cash
12/31/7x

Schedule ______ Date
Prepared by JG 7/15/7x
Approved by RP 7/17/7x

Acct. 101 - General account, First National Bank

		5/31/7x	Receipts	Disbursements	6/30/7x
Balance per bank	①	[illegible]	[illegible]	[illegible]	[illegible]
Deposits in transit—					
5/31	②	[illegible]	[illegible]		
6/30	②		[illegible]		[illegible]
Outstanding checks—					
5/31	③	[illegible]		[illegible]	
6/30	③			[illegible]	[illegible]
NSF checks	④		[illegible]	[illegible]	
Bank debit memos	⑤			[illegible]	[illegible]
Payroll checks erroneously in Cash Disbursements Journal	⑥			[illegible]	[illegible]
To allow for effect of a cash disbursement recorded as a credit item in Cash Receipts Journal			[illegible]	[illegible]	
Subtotal reconciling items		[illegible]	[illegible]	[illegible]	[illegible]
Balance per books		[illegible]	[illegible]	[illegible]	[illegible]

date a check is drawn on one bank account and immediately deposited in a second account for credit before the end of the accounting period. In making this transfer, the embezzler is careful to make sure the check is deposited at a late enough date so that it does not clear the first bank until after the end of the period. Assuming the bank transfer is not recorded until after the balance sheet date, the amount of the transfer is recorded as an asset in both banks. Although there are other ways of perpetrating this fraud, each involves the basic device of increasing the bank balance to cover a shortage by the use of bank transfers.

A useful approach to testing for kiting, as well as for unintentional errors in recording bank transfers, is to list all bank transfers made a few days before and after the balance sheet date and trace each one to the accounting records for proper recording. For example, if a bank transfer is recorded in the current period as a disbursement, the auditor should examine the bank cancellation date on the check to see when it cleared. If the check cleared after the balance sheet date, it should be included as an outstanding check. Similarly, transfers deposited in the bank near the end of the year or included as deposits in transit can be traced to the cash receipts or disbursements journal to make sure they have been recorded in the journals in the proper period. For example, if a transfer was received by the bank and included as a deposit in transit on the bank reconciliation, kiting has probably occurred.

Even though audit tests of bank transfers are usually fraud oriented, they are often performed on audits where there are numerous bank transfers, regardless of the system of internal control. When there are numerous intercompany transfers, it is difficult to be sure each one is correctly handled unless a schedule of transfers near the end of the year is prepared and each transfer is traced to the accounting records and bank statements. In addition to the possibility of kiting, inaccurate handling of transfers could result in a misclassification between cash and accounts payable. The materiality of transfers and the relative ease of performing the tests make many auditors believe they should always be performed.

Summary. In designing audit procedures for uncovering fraud, careful consideration should be given to the nature of the weaknesses in the system of internal control, the type of fraud that is likely to result from the weaknesses, the potential materiality of the fraud, and the audit procedures that are most effective in uncovering the error. When the auditor is specifically testing for fraud, he should keep in mind that audit procedures other than direct tests of cash balances can also be useful. Examples of procedures that may uncover fraud in the cash receipts area include the confirmation of accounts receivable, tests for lapping, reviewing the general ledger entries in the cash account for unusual items, tracing from customer orders to sales and subsequent cash receipts, and examining approvals and supporting documentation for bad debts and sales returns and allowances. Similar tests can be used for testing for the possibility of fraudulent cash disbursements.

ATTACHMENT 2

ABRAHAM J. BRILOFF

The Truth About Corporate Accounting

1817
HARPER & ROW, PUBLISHERS, New York
Cambridge, Hagerstown, Philadelphia, San Francisco
London, Mexico City, São Paulo, Sydney

For Audit Committees of Boards of Directors

The process of corporate accountability for publicly owned corporations is moving at an accelerating rate to include among their boards of directors duly constituted audit committees.

In its 1977 Report, *Improving the Accountability of Publicly Owned Corporations and Their Auditors*, the Metcalf Committee urged the adoption of this proposal by all publicly owned corporations. In the view of the Committee, "Audit committee members should be free of any significant involvement with the management of a corporation, such as commercial or investment banking relationships, outside legal counsel, management consulting, or major commercial relationship."

The major purpose of such a committee should be "to handle relations with the independent auditor, improve internal auditing controls, and establish appropriate policies to prohibit unethical, questionable, or illegal activities by corporate employees."

The New York Stock Exchange, which had been considering such a policy, moved to require that all domestic corporations listed on the exchange create audit committees by July 1, 1978. The SEC, in its July, 1979, report to the Congress, commended the NYSE for its action and indicated that the National Association of Security Dealers and the American Stock Exchange were considering corresponding actions. The report made reference to the Commission's revised proxy rule which would require "disclosures as to the composition of audit committees and the functions they perform."

The AICPA had established a special committee to study the feasibility of introducing an auditing or ethical standard which would require that publicly owned corporations create independent audit committees. That special committee of the AICPA concluded, in December, 1978, that the organization was powerless to mandate such audit committees. In its report, the special committee indicated that it had been advised by counsel that the imposition of an audit-committee requirement in the absence of a reasonable foundation would expose the AICPA and its members to a risk that established antitrust principles would be violated. The AICPA pointed out, however, that it "continues to support the establishment of audit committees and is prepared to support efforts by others having authority to require audit committees where such requirements give due recognition to a reasonable cost-benefit relationship."

I believe the AICPA was overly concerned about the antitrust and other implications of a firm position on audit committees. I see no reason why the independent auditor's detailed audit of the audit committee's structure and operation should not be an essential extension of the auditor's study of his client's internal-control organization and functioning.

I would, in fact, expect the independent auditor to comment critically where he finds the presumptive independent, conscientious, and effective audit committee to exist merely as a paper committee. In short, if the independent auditor finds the members of the independent audit committee to be other than really independent as the auditor judges independence, I expect him to make that fact known, and to tell why. And if he finds the committee functioning in a manner inconsistent with the standards presumed for such a committee, I would expect him to blow the whistle, just as he undoubtedly would if he found the bookkeeper dipping into the petty cash box.

True, such a cussed independence on the part of the independent auditor might make him *persona non grata* with a less-than-independent audit committee. Such a committee might even go looking for another auditor; but virtue is not necessarily free from cost.

What is the role of the audit committee? What are its functions? A frame of reference for such a committee may be found in the decree settling the litigation brought by the Securities and Exchange Commission against Killearn Properties, Inc. That determination directed that an audit committee be formed comprised of "at least three persons who shall be members of the Board and outside directors . . ." and have the following responsibilities:

> i. It should review the engagement of the independent accountants, including the scope and general extent of their review, the audit procedures which will be utilized, and the compensation to be paid.
>
> ii. It should review with the independent accountants and with the company's chief financial officer (as well as with other appropriate company personnel) the general policies and procedures utilized by the company with respect to internal auditing, accounting, and financial controls. The members of the committee should have at least general familiarity with the accounting and reporting principles and practices applied by the company in preparing its financial statements.
>
> iii. It should review with the independent accountants, upon completion of their audit, *(a)* any report or opinion proposed to be rendered in connection therewith; *(b)* the independent accountants' perceptions of the company's financial and accounting personnel; *(c)* the cooperation which the independent accountants received during the course of their review; *(d)* the extent

to which the resources of the company were and should be utilized to minimize time spent by the outside auditors; *(e)* any significant transactions which are not a normal part of the company's business; *(f)* any change in accounting principles; *(g)* all significant adjustments proposed by the auditor; *(h)* any recommendations which the independent accountants may have with respect to improving internal financial controls, choice of accounting principles, or management reporting systems.

iv. It should inquire of the appropriate company personnel and the independent auditors as to any instances of deviations from established codes of conduct of the company and periodically review such policies.

v. It should meet with the company's financial staff at least twice a year to review and discuss with them the scope of internal accounting and auditing procedures then in effect; and the extent to which recommendations made by the internal staff or by the independent accountants have been implemented.

vi. It should prepare and present to the company's board of directors a report summarizing its recommendation with respect to the retention (or discharge) of the independent accountants for the ensuing year.

vii. It should have the power to direct and supervise an investigation into any matter brought to its attention within the scope of its duties (including the power to retain outside counsel in connection with any such investigation).

In addition, the Audit Committee shall have the following special duties, functions and responsibilities:

viii. Review, either by the Committee as a whole or by a designated member, all releases and other information to be disseminated . . . [by the company] to press media, the public, or shareholders . . . which concern disclosure of financial conditions of and projections of financial conditions. . . .

ix. Review of the activities of the officers and directors of Killearn as to their future dealing with the company and take any action the Committee may deem appropriate with regard to such activities. . . .

Mr. Justice Goldberg's Proposals

When, in late 1972, Arthur J. Goldberg resigned from membership on TWA's board of directors, he described the difficult plight of a conscientious director, saying, "The outside director is simply unable to gather enough independent information to act as a watchdog or sometimes even to ask good questions. When presented with the agenda of the board meeting, the director is not basically equipped to provide any serious input into the decision. Realistically, it has already been made by management. . . ."

To help remedy this condition he proposed the establishment of a "committee of overseers of outside directors." Such a committee would be "generally responsible for supervising company operations on a broad scale and make periodic reports to the board." To permit the effective fulfillment of the committee's responsibilities, the former justice proposed:

> To perform these duties adequately this committee would need authorization to hire a small staff of experts who would be responsible only to the board and would be totally independent of management control. In addition, the committee should also be empowered to engage the services of consultants of the highest competence.
>
> As the eyes and ears of the directors, these independent experts and their staff assistants and consultants would look into major policy questions and report to the committee and through them to the board as a whole before decisions are taken on management recommendations.
>
> The fundamental responsibility of these experts, staff, and consultants would be to provide an independent source of expertise for the board. . . . In addition, it would reassert the position of the board as a focal point for creative policy input for corporate decisions.
>
> • • •
>
> The membership of this group of expert advisers should include representatives from widely divergent areas of expertise.
>
> For technical aspects of product-line development, scientific advisers should be recruited. For a look at future markets and the desires of the public, a demographic expert and consumer adviser should be consulted. To ensure compliance with truth-in-advertising standards, an outside advertising consultant might be utilized.
>
> Other possible experts might include an independent auditor to assure the soundness of the accounting techniques used by the corporation and a disinterested independent financier (for example, a retired executive of an investment banking house) to ascertain whether the operations are being frugally financed.
>
> Finally, some employee representatives might be consulted for their independent view of the performance of the corporation from their perspective. Permanent staff assistants to the overseer committee could perform most of the investigative work necessary for the use of the experts.

In short, such a committee of the board should be capable of probing and judging the decision making of the corporate enterprise to assure its optimal functioning in behalf of shareholders, creditors, employees, governments, and the public in general.

Senator Metzenbaum's Proposals

Also of interest in this connection are the provisions of a bill introduced by Senator Howard Metzenbaum in April, 1980. That bill (S. 2567), *The Protection of Shareholders' Act of 1980*, was intended "to establish Federal minimum standards relating to composition of corporate boards, duties of corporate directors, audit and nomination committees, shareholders' rights and for other purposes."

This bill would apply to publicly owned American corporations with 500 or more shareholders and with substantial properties or sales volume (as defined by the bill, Section 3).

To begin with, such corporations would be constrained to elect to their boards of directors a majority of independent directors, i.e., those who have no conflicting entangling alliances with the corporation or its chief executive (as defined by Section 5).

And then, the affected entities were to be required to have audit committees comprised entirely of such independent directors; S. 2567 then sets down certain of the duties of that committee, to wit:

Audit Committee

> Sec. 6. (a) The board of directors of an affected corporation shall establish and maintain an audit committee composed solely of persons who are not described in subsection (b) of section 5 of this Act.
>
> (b) It shall be the function of the audit committee, in addition to any other functions agreed to by the board of directors, to—
>
> (1) review the arrangements and scope of the independent audit examination;
>
> (2) review, upon completion of the audit, the following items with the principal firm of independent auditors engaged by the affected corporation:
>
> (A) any report or opinion proposed to be rendered in connection with the audit;
>
> (B) the extent to which the resources of the affected corporation were and should be utilized to minimize the time spent by the independent auditors;
>
> (C) any significant transactions detected during the audit which were unrecorded, unauthorized, or not adequately supported;

(D) any material change in the affected corporation's accounting principles;

(E) all significant adjustments proposed by the auditor;

(F) the scope of the auditor's examination; and

(G) any recommendations which the independent auditors may have with respect to improving internal accounting controls and choice of accounting principles;

(3) investigate and make recommendations concerning the cooperation which the independent auditors received from officers and employees of the affected corporation during the conduct of the audit;

(4) subject to the approval of a majority of the outstanding shares of the affected corporation, hire and dismiss the independent auditors and determine the compensation which they shall be paid;

(5) inquire of appropriate company personnel and the independent auditors as to any instances of deviations from the affected corporation's established codes of conduct and periodically review such policies;

(6) meet with the affected corporation's chief financial officer and other appropriate personnel at least twice a year to review and discuss with them the general policies and procedures utilized or proposed to be utilized by the affected corporation with respect to internal accounting controls, including the internal audit function;

(7) direct and supervise an investigation into any matter brought to its attention with the scope of its duties;

(8) review executive perquisites;

(9) report on the committee's activities in the annual report to shareholders; and

(10) review, either as a committee of the whole or by a designated member, all releases and other information to be disseminated by the affected corporation to the press media, the public, or its shareholders which concern disclosures of financial condition and results of operation, or forecasts of such information, of the affected corporation and its subsidiaries.

(c) Pursuant to performing the function specified in paragraph (6), the audit committee shall have the power to retain outside counsel in connection with any investigation.

A January, 1979, New York Stock Exchange publication reported on a questionnaire directed to the 1,700 members of the American Society of Corporate Secretaries (hence, identified with publicly owned corporations required to report to the SEC). According to that study, "audit committees are entirely comprised of non-management directors for 92 percent of respondent companies, 96 percent of New York Stock

Exchange respondent companies." Further, the Exchange report cited the fact that it was subsequently determined that "only one New York Stock Exchange respondent company's audit committee was not entirely comprised of non-management directors."

How did the survey define "non-management director?" This critical phrase, for purposes of the questionnaire, meant "any person who is independent of management and free from any relationship that, in the opinion of the board of directors of the company, would interfere with the exercise of independent judgment as a board member." This definition involves tautology. It would be of at least academic interest if the proxy material and annual reports which list the ostensibly non-management directors provided in reasonable detail a statement of the relations such members and/or their firms may have had with the corporate entity over the past five years, say.

I consider the survey especially significant since the New York Stock Exchange requirement for an audit committee was specifically rephrased to exclude the requirement for independent directors; the phraseology used in the Metcalf Committee report cited early in this chapter should have been adopted as the standard for determining independence. Regrettably, the Exchange bowed to expedience in the face of stiff opposition—and accepted the definition of "non-management director" in the corporate secretaries' questionnaire.

I will close this segment on a positive note: There is little question that an independent audit committee as suggested by the Metcalf Committee report, functioning along the lines implicit in Arthur Goldberg's proposals, devoting adequate time to the fulfillment of its responsibilities, would contribute to the corporate entity's optimal performance. Such performance could go far to restore the public's confidence in the private sector—and in the public sector too (since so many of the failings in the latter in recent years are rooted in aberrations by the former).

Myths vs. Realities

Ironically these new proposals to advance corporate governance and accountability do little more than return full circle to what was presumed in this regard in a more bucolic period in history. For example, when Francis W. Pixley, at the turn of the century, described the role of the auditor (in Great Britain), he noted that "The Shareholders [he wrote it with a capital S] of a Company may, therefore, be said to have two representatives of their interests . . . the Directors, [and] *their* Auditor" [emphasis mine].

Some forty years ago the late Justice William O. Douglas discerned the disparity between the myth and reality regarding corporate boards of directors. He observed that when the ordinary citizen or the ordinary stockholder thinks of the board of directors, he thinks of them "as distinct from and superior to the management." Such a view presumes that the directors are of such caliber that management will seek their advice and that they "will exercise independent judgment on corporate problems." Douglas then concluded that "this kind of director is too often nothing more than a myth."

This problem is exacerbated by the accelerating concentration of share ownership in disembodied funds of various kinds (mutual, trust, pension, insurance, and the like), and also by the acquisitive takeover pursuits of conglomerates and other entities bent upon empire building.

The remarks by Senator Metzenbaum when submitting his S. 2567 to the Senate on April 16, 1980, included the following:

> In theory, a major responsibility of a corporation's board of directors is to carefully monitor corporate policy in order to prevent abuses of this kind. But in fact, a very large number of corporate boards do not exercise meaningful oversight and control over management. "Directors," complained William O. Douglas as early as 1933, "do not direct."
>
> In a 1975 survey of 394 of the country's largest corporations. Korn/Ferry International—a New York executive recruiting firm—found that boards averaged only seven meetings per year. "In most large corporations," Korn/Ferry reported, "the board meetings have withered, through neglect, into a ritualized 1- to 3-hour ceremony with much of the time being consumed by a pro forma review of operations by the president or vice presidents and equally routine approvals of the capital appropriations that management wants."
>
> Perhaps the best illustration of the failure of many corporate boards to exercise meaningful oversight and control over management is the Penn Central failure. At the time of the collapse in June 1970, Penn Central was the largest railroad in the country and the sixth largest industrial corporation overall. Within a 2-year period, shareholders watched their shares plummet from 86½ to 2¾. A director who joined Penn Central in December 1969 gave the following, devastating description of board attitudes:
>
>> They sat up there on the eighteenth floor in those big chairs with the (brass name) plates on them and they were a bunch of, well, I'd better not say it. The board was definitely responsible for the trouble. They took their fees and they didn't do anything. They didn't know the factual picture and they didn't try to find out.

In testimony before the Senate Commerce Committee a few years ago, former SEC Chairman Roderick Hills summed up the situation as follows:

> Too many boards are dominated by inside directors. Even where there are significant numbers of outsiders on a board, they are all too often old friends of the chief executive office who would rather resign from the board than severely criticize or vote to oust their old friend.

When it is recognized that corporate accountability extends to all of society, these endeavors by the NYSE, the SEC, the Congress, and it is hoped, even by the AICPA, should have a salutary effect. But, in truth, the answer to Juvenal's question must be, "The ultimate guardian of the guardian must be the guardian himself." If there is not something of a "born-again morality," all this tinkering will be an expensive voyage to Erewhon.

ATTACHMENT 3

IX. STANDARDS FOR CORPORATE GOVERNANCE

The problems that are the subject of this report, particularly those involving the cash management system, were in large part attributable to potential flaws in Hutton's system of corporate governance in 1980-82. In evaluating that system, we began by reflecting on certain basic principles of corporate governance, both as established by law and as suggested by respected authorities. It was against these guideposts that we assessed the sufficiency of Hutton's system of corporate governance. We reiterate those basic principles *seriatim* here before moving to a specific assessment of Hutton's system.

A. The Need for Internal Controls

The Foreign Corrupt Practices Act ("FCPA") became law on December 19, 1977. Although the FCPA is generally known for its prohibition of foreign bribes, the FCPA also contains provisions imposing certain record-keeping and accounting duties on public companies. Those requirements have been incorporated into the Securities Exchange Act of 1934. It is clear from the FCPA's legislative history, as well as from the face of the FCPA itself, that the record-keeping and accounting requirements of the FCPA stand on their own and apply to all

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corporate activities. See S.E.C. v. World-Wide Coin Investments, Ltd., 567 F. Supp. 724 (N.D. Ga. 1983).

The FCPA generally requires public companies to keep accurate books and records that fairly reflect their financial transactions. The FCPA specifically requires that companies, like Hutton, "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurance that . . . (i) transactions are executed in accordance with management's general or specific authorization." 15 U.S.C. § 78m(b)(2)(B).

Shortly after the FCPA became effective, the Securities and Exchange Commission issued a release putting issuers, accountants, attorneys and other interested persons on notice of the passage of the FCPA. Accounting Release No. 242, Fed. Sec. L. Rep. (CCH) ¶ 72,264 (Feb. 24, 1978). The release highlighted the new requirements with respect to the maintenance of internal accounting controls and stated that "[i]t is important that issuers . . . review their accounting procedures, systems of internal accounting controls and business practices in order that they may take any actions necessary to comply with the requirements contained in the Act." Id.

Subsequently, in addressing the adequacy of an internal control systems, SEC Chairman Harold Williams offered the following remarks in a January 1981 speech:

> With respect to issuer liability for record keeping violations, we look to the adequacy of the internal control system of the issuer, the involvement of top management in the violation, and the corrective actions taken once a violation was uncovered. If a violation was committed by a low level employee, without the knowledge of top management with an adequate system of internal control, and with appropriate corrective action taken by the issuer, we do not believe that any action against the company would be called for.

Speech by Harold M. Williams, Chairman of the Securities and Exchange Commission, before SEC Developments Conference, American Institute of Certified Public Accountants [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,810 at 83,937 (Jan. 13, 1981).

In further discussing the internal control requirements of the FCPA, Williams said:

> This concept is not a mandate for Board - or even most senior management - involvement in the minutia of recording and accounting for every transaction which the company may make. But, it does mean that both management and the Board have important roles to play in monitoring and evaluating the adequacy of the company's records and controls systems.
>
> This standard is not satisfied if a company's leadership, while making nominal gestures of compliance, abdicates its responsibilities to foster integrity among those who operate the system. Regardless of how technically sound an issuer's controls are, or how impressive they appear on paper, it is unlikely the control objectives will be met in

> the absence of a supportive environment. In the last analysis, the key to an adequate "control environment" is an approach on the part of the Board and top management which makes clear what is expected, and that conformity to these expectations will be rewarded while breaches will be punished.

Id. The role of audit committees under the FCPA was also addressed by Mr. Williams when he stated that "effective audit committees composed of independent directors are the best assurance that meaningful internal controls will be established and enforced." Id. at 83,938.

Although there is nothing in the FCPA's provision or in the rules and regulations of the SEC that specifically require an issuer to have internal auditors, it is difficult to imagine an adequate control system within the meaning of the FCPA's provisions without the utilization of internal auditors. As noted by Mr. Williams,

> The increasing acceptance of the internal auditor as an important management professional has been yet another major contributor to the quality and credibility of internal control systems. And, while traditionally internal auditors reported exclusively to more senior management, a recent study indicates that one-third of internal auditors now report directly to the board or the audit committee and that many others have direct access.

Id. This message was mirrored in the District Court's discussion of internal controls in World-Wide Coin:

> The internal controls requirement is primarily designed to give statutory content to an aspect of management stewardship responsibility, that of providing shareholders with reasonable assurances that the business is adequately controlled.

AVAILABLE

> . . . .
>
> Among the factors that determine the internal accounting control environment of a company are its organizational structure, including the competence of personnel, the degree and manner of delegation and responsibility, the quality of internal budgets and financial reports, and the checks and balances that separate incompatible activities. The efficiency of the internal control system of a company cannot be evaluated without considering the company's organizational structure, the caliber of its employees, *the strength of its audit committee, the effectiveness of its internal audit operation*, and a host of other factors which, while not part of the internal control system itself, have an impact on the function of the system.
>
> Although not specifically delineated in the Act itself, the following directives can be inferred from the internal controls provisions: (1) Every company should have reliable personnel, which may require that some be bonded, and all should be supervised. (2) Account functions should be segregated and procedures designed to prevent errors or irregularities. The major functions of recordkeeping, custodianship, authorization, and operation should be performed by different people to avoid the temptation for abuse of these incompatible functions. (3) *Reasonable assurances should be maintained that transactions are executed as authorized*. (4) Transactions should be properly recorded in the firm's accounting records to facilitate control, which would also require standardized procedures for making accounting entries. *Exceptional entries should be investigated regularly*. . . .

567 F. Supp. at 750 (emphasis added).

B. Other Basic Principles of Corporate Governance

Since 1980, the Reporters from the American Law Institute ("ALI") have worked on a draft of the Principles of

Corporate Governance that would apply to corporations and other business entities. The Reporters published tentative drafts numbers two and three of the Principles (the "Principles") in April 1984. Principles of Corporate Governance § 1.01 et seq. (Tent. Draft No. 2 1984) and § 4.01 et seq. (Tent. Draft No. 3 1984).[119]

The Principles reflect a body of standards that have evolved over the years in the area of corporate governance. Although they do not carry the weight of law, they do set forth standards of proper and ethical business conduct. In that regard they are applicable to this matter and are particularly helpful in assessing Hutton's system of corporate governance.

Section 2.01 provides that a corporation "is obligated . . . to act within the boundaries set by law" and to

> take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business. In determining its legal obligations, a corporation should not rest simply on past precedents or an unduly literal reading of statutes and regulations, but should give weight to all the considerations that the courts would deem proper to take into account in their determination, including relevant principles, policies, and legislative purposes.

Principles § 2.01 (Tent. Draft No. 2 1984).

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[119] The drafts have not yet been considered by the members of the ALI but they are valid collections of standards and principles on this subject.

Section 3.01 provides that "[t]he management of the business of a publicly held corporation . . . should be conducted by or under the supervision . . . of senior executives . . . and by those other officers and employees to whom the management function is delegated." Id. § 3.01. For the purposes of this section, officers include among others, the operating, financial, legal and accounting officers of the corporation. Id. § 1.19. In managing the corporation, senior executives and others who are delegated authority "are obligated to act in a manner that is consistent with the principles of § 2.01." Id. § 2.01 comment (c).

The composition of the Board of Directors of a company the size of Hutton is specifically addressed by section 3.04 of the Principles, which provides:

> The board of every large publicly held corporation . . . shall have a majority of directors who are free of any significant relationship . . . with the corporation's senior executives . . . .

Id. § 3.04. The requirement that a board be composed of a majority of nonaffiliated directors embodies the principle that a board cannot properly function unless "a board can objectively evaluate the performance of the senior executives, and an accurate and reliable flow of information to the board concerning that performance." Id. § 3.04 comment (c). This principle has apparently received broad acceptance. Recent studies show that, of the large public corporations surveyed, *at least* half of the directors are outside directors. Some studies show the percent to be as high as 61 percent.

The Principles also address the composition of director nominating committees. The Principles provide that large public corporations "have a nominating committee to oversee the process of nomination to the board." The rationale for this requirement is the same as that for the composition of the board itself. *See id*. § 3.06 comment (c).

With regard to supervision of the operation of the corporation, the Principles strongly support independent audit committees. Section 3.03 provides:

> Every large publicly held corporation . . . should have an audit committee, to oversee the audit process . . . composed of [outside] directors . . . including at least a majority of members who have no significant relationship with the corporation's senior executives.

Id. § 3.03. The rationale for audit committees is stated in accompanying comments. Among other things, the comments note that the audit committee serves an important adjunct to the board by providing, *inter alia*, "continuing review and detailed discussion of financial data and accounting controls." *Id*. § 3.03 comment (c)(i). The Reporters' notes specifically consider the relationship of the audit committee to obligations imposed by the FCPA.

> While not generally considered an element of an accounting control system, the presence or absence of an audit committee may bear upon an assessment of a publicly held corporation's compliance with the Foreign Corrupt Practices Act, which requires most publicly held corporations to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are executed in accordance with management's authorization, and are recorded so as to permit preparation of proper financial statements and maintain accountability for assets.

Id. § 3.03 note 2.

The duties owed by individuals to the corporation are incorporated in the Business Judgment Rule, which has been incorporated into the Principles. That rule of longstanding acceptance provides in pertinent part:

> A director or officer has a duty to his corporation to perform his functions in good faith, in a manner that he reasonably believes to be in the best interests of the corporation and otherwise consistent with the principles of § 2.01, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.[128]

Principles § 4.01(a) (Tent. Draft No. 3 1984). The duty to perform in the best interest of the corporation obviously implies a duty to supervise and a duty to inquire where warranted. The latter duty arises if it is reasonably called for by specific facts and circumstances, which would be the case where the officer actually believes that inquiry is required or if he would be unreasonable in not having such a belief. *Id*. § 4.01(b) comment (b).

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[128] This is the standard which is incorporated in New York law. N.Y. Bus. Corp. Law § 717 (Consol. Supp. 1979). It is similar to the standard under common law of Delaware (care that an ordinary prudent person would exercise under similar circumstances).

That duty of care includes the duty to exercise reasonable oversight and supervision by directors over executive officers and by executive officers over officers and agents under them.[121] *Fletcher Cyc. Corp.* § 1070 (1975 perm. ed.). The business judgment rule will not insulate directors and officers from liability for actions resulting "from an obvious and prolonged failure to exercise oversight and supervision." *Joy v. North*, 692 F.2d 880, 886 (2nd Cir. 1982), *cert*. *denied*, 460

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[121] Courts have articulated varying standards for what constitutes "reasonable supervision." In Delaware, officers and directors may be liable for any resulting loss if "something occurs to put them on suspicion that something is wrong", and they do not take action. *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963). In other, less hospitable, jurisdictions directors and officers may be liable for the acts of other corporate officers in which they did not participate if (i) they had some knowledge by which they could have prevented the loss with the exercise of reasonable care or (ii) they failed to exercise authority they possessed to prevent losses which should, in the exercise of reasonable care and skill, have been foreseen and guarded against. *See*, *e.g.*, *People v. Equitable Life Assurance Society of the United States*, 124 App. Div. 714, 109 N.Y.S. 453 (1908); *see also* *Fletcher Cyc. Corp.* § 1070 (1975 perm. ed.).

U.S. 1051 (1983), *citing* *McDonnell v. American Leduc Petroleums, Ltd.*, 491 F.2d 380 (2d Cir. 1974) and *Atherton v. Anderson*, 99 F.2d 883 (6th Cir. 1938).

Section 4.02 of the Principles entitles an officer to rely on those selected to perform other duties in the corporation. The section provides:

> In performing his duties and functions, a director or officer is entitled to rely on . . . information, opinions, reports, statements (including financial statements and other financial data), or decisions [or] judgments . . . prepared, presented, made or performed by:
>
> > (a) . . . directors, officers, or employees of the corporation . . . whom the director or officer reasonably believes to be competent as to the matters presented, or
> >
> > (b) Legal counsel, public accountants, engineers, or other persons as to matters the director or officer reasonably believes are within the person's professional or other competence.
>
> A director or officer is not, however, entitled to rely on such information, opinions, reports, statements, decisions, judgments, or performance if his reliance is not in good faith or if he knows or, using . . . reasonable care should know that such reliance is unwarranted.

Principles § 4.02 (Tent. Draft No. 3 1984). The comments to the Principles state that the section "provides protection for directors and officers who properly rely on other persons and assert this reliance as evidence of reasonable conduct." *Id.* § 4.02 comment c. With regard to officers, the comments note that "the greater obligation of officers to be familiar with the affairs of the corporation should not bar them from all reliance protecton." Id. § 4.02 comment d.

It is against the framework of these recognized principles that we make our assessment of Hutton's system and the conduct of its personnel.

ATTACHMENT 4

ABRAHAM J. BRILOFF

The Truth About Corporate Accounting

HARPER & ROW, PUBLISHERS, New York
Cambridge, Hagerstown, Philadelphia, San Francisco
London, Mexico City, São Paulo, Sydney
1817

made passing reference to the apparent failure on the part of ITT's general counsel as well as independent counsel in the conduct of their special investigation. Here I put the same challenge to the lawyers on the SEC staff that I have put to my colleagues in the accounting profession, "Have you or will you be forwarding the file in this matter to the appropriate disciplinary committees of the bar associations for their inquiry into the competence and diligence of the lawyers who pursued this special investigation?"

By now you must know what the consequences were for all this naughtiness. Of course, it was a consent decree whereby ITT neither admitted nor denied the allegations, tra la, tra la, tra la.

Oh yes, ITT will create another investigative committee and presumably, ITT will be enjoined from violating the laws of our nation—otherwise the Geneen machine rolls along unobstructed and uninhibited.

But I have another complaint—one which the SEC did not raise. ITT's independent auditor, which failed to blow the whistle, was and is Arthur Andersen and Co. Arthur Andersen and Co. turned up as the white-knight accounting consultant to Lockheed's Special Review Committee probing the grease in that entity. You might remember that in my discourse on that sad saga I inquired as to why Arthur Andersen did not probe more diligently the rationalizations by Lockheed's auditor (Arthur Young & Co.) regarding that auditor's failure to decry misdeeds. Is it not likely that Arthur Andersen was mindful of Scripture which enjoins, "Let him who is without sin blow the first whistle"?

Neither Arthur had a vision of Excalibur! I maintain that the SEC should refuse to allow special reviews pursuant to an accord with the Commission or a court (pursuant to an SEC action) to be undertaken by an accounting firm identified with any similar action (concluded or pending) before the Commission.

The FCPA Enactment

To put an end to these "grease" practices, the Congress enacted the Foreign Corrupt Practices Act of 1977 (FCPA). This legislation was designed to prohibit what President Carter called "ethically repugnant and competitively unnecessary" conduct. Along with prohibiting companies from engaging in certain corrupt practices with respect to foreign officials, the act amends Section 13(b) of the Securities Exchange Act of 1934 to require reporting companies to make and keep accurate books and records and to establish and maintain a system of internal accounting controls which meet certain objectives.

Corrupting the FCPA

Surely, this legislation should have given rise to a hosanna from my colleagues in practice; the Congress had given legislative approval to our auditing standards pertaining to internal control. Our corporate clients were told that henceforth their endeavors to mislead us might lead to criminal indictments and even convictions. This was something which many of my colleagues were urging in the wake of Corporate Watergate. How did the accounting profession respond to this new congressional mandate?

Sadly, this new cloak of authority and legitimacy for our profession was too heavy for our shoulders. In any event, my colleagues determined to join with corporate managements in resisting the endeavors by the Securities and Exchange Commission to implement the legislation.

An obituary for the brave new world created by the FCPA appeared in the January 19, 1980, *Economist:* "SEC-Softer Yet: A staged retreat by the Securities and Exchange Commission threatens to become a rout as it thinks again about how to interpret the accounting provisions of anti-bribery laws."

The reason for this lament was the negative response from the business community (and their stalwart professional representatives) to the April, 1979, SEC proposals to give effect to the accountancy provisions of the 1977 enactment. Even these proposed regulations were watered down. All that was to be required was: First, that the books, records, and accounts accurately and fairly reflect, in reasonable detail, the transactions and disposition of assets, and, second, that companies must devise and maintain a system of internal controls.

The SEC then, in line with what it saw as Congress's intent, also proposed that, after December 14, 1979, annual reports should contain a statement from management saying the internal controls provided "reasonable assurance" of achieving their objectives, and a year later should contain an auditor's certified opinion on this management statement.

Those familiar with the history of the legislation might recall that when, in 1976, the FCPA was going through the congressional mill, the then SEC Chairman Roderick Hills stated flatly: "upon passage of this legislation we would, of course, impose a requirement upon outside auditors that they certify the adequacy of such (internal) controls."

This promise notwithstanding, in November 1979, the SEC, now under President Carter's Chairman Williams, withdrew the proposed implementation rules for further deliberations. This abdication of responsibility by the SEC (permitting a corresponding abdication by my colleagues in the accounting profession) has not induced distress among my colleagues.

The FCPA: "RIP"

If the foregoing was the obituary for the SEC's endeavors to implement the congressional mandate insofar as the internal control provisions of the FCPA were concerned, its requiem was "sung" in a June 6, 1980, "Statement of Management and Internal Accounting Control: Withdrawal of Proposed Rules."

According to this promulgation, the SEC's decision to abort the proposed certification requirements was motivated, in part, by its "determination that the private sector initiatives . . . have been significant and should be allowed to continue."

The Commission will be studying the progress of these "private initiatives" over a three-year period, and then will give further consideration to any required rule making.

Spring, 1980, most certainly afforded the Commission a solid basis for hoping that the private sector will, in fact, proceed to develop the initiatives for effective disciplining of the internal control system, at all levels of the corporate structure, and that the independent attesting auditors would proceed diligently to point up and act with intrepidity to weed out any misuses and abuses of corporate resources—even if such misuse and abuse should occur at the highest levels of their clients' organization.

After all, did not the spring of that year produce the miracles wrought by Genuine Risk and Temperence Hill?

Baruch College
The City University of New York
17 Lexington Avenue
New York
N.Y. 10010

add 59-416
at p. 1284

April 7, 1986

The Honorable William Hughes, Chairman
Subcommittee on Crime
Committee on the Judiciary
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Hughes:

On October 3, 1985, at the invitation of your Committee I testified in its probe of the E.F. Hutton matter. My principal frame of reference related to what I perceived to be the critical failure of corporate governance and accountability at that major financial institution, hence the title theme of my prepared statement, "Corporate Governance and Accountability: The E.F. Hutton 'Sindrome.'"

I
Introduction

I was the initial witness and during the course of my testimony I criticized the conduct of Arthur Andersen & Co. ("AA"), Hutton's independent auditor, as well as Hutton's independent audit committee, directors and management. Further, I critized what I dubbed the "greywash," i.e., the Report of Judge Griffin Bell on his investigation. Subsequent witnesses represented Arthur Andersen & Co. and Arthur Young & Co. (an accounting firm which had studied Hutton's cash-management procedures with a view towards their consistency with what they presumed to be legal and prudent).

I was present throughout these subsequent proceedings. There were a number of matters raised by the testimony of Joel E. Miller, CPA, the Arthur Andersen engagement partner for the Hutton audit, and by a series of memoranda first made available to the public (and to me) during the course of his testimony, which I found so significant as to require a response from me. I regret that various matters intervened to prevent me from responding heretofore; accordingly, I do not know whether this commentary can be included in the Record of the Committee's Hearings, or even considered by you in your deliberations. Nonetheless, I am submitting this as an extension of my testimony in fulfillment of what I perceive to be my professional responsibility. Specifically, I will address this critique to two aspects of these auditing and accountability deliberations, thus:

1. The failure of Hutton's independent auditors to implement the procedures to which they committed themselves, according to the concluding paragraph of a March 7, 1980, Arthur Andersen memorandum* (relating to a March 5 meeting) to wit:

> After the discussion of the procedures employed and their legality, Joel Miller, AA & Co. engagement partner, requested that Tom Rae render a written legal opinion stating that Hutton's activities in this area don't present any potential legal problems. Mr. Rae declined to render such an opinion, stating that the banks are fully cognizant of Hutton's procedures, that this is an accepted banking practice and that there is no question as to the propriety of such transaction, again making reference to the "means of payment" principles. After Tom Rae declined to issue an opinion on this matter, Bill Sullivan offered to call one of the banks Hutton uses, Morgan Guaranty, and ask them what the banks would do if a company were to issue checks with no book balances (i.e., such as Hutton's segregated commodity balances). Joel Miller than stated that he would discuss the matter with other partners at AA & Co. whose clients include major money center banks to ascertain what the bank's "point of view" is regarding these transactions. (Emphasis supplied.)

2. The failure on the part of Arthur Andersen & Co. to proceed with responsibility and due diligence in its relationship with E.F. Hutton's independent audit committee of its board of directors.

II
Regarding AA's Failure to Follow Through on Its March 5, 1980 Undertaking

Your Committee questioned Mr. Miller most intensely and extensively regarding his course of conduct following the March 5, 1980, meeting (as described in the aforementioned memoradum). He was interrogated regarding his commitment to follow through by discussing "the matter with other partners at AA Co. whose clients include major money center banks to ascertain what the bank's point of view is regarding these transactions."

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* This memorandum was included as pages 7-8 of my prepared statement; it is included herein as Exhibit A for convenient reference.

Mr. Miller's response was to the effect that he returned to his office, brooded about the problem, reflected on about a hundred bank confirmations and determined to accept Hutton's money-management proclivities as entirely appropriate. His responses are rationalizable only to the extent he was constrained to rationalize what he undoubtedly knew was a failure to fulfill an auditor's responsibility to demonstrate a "healthy skepticism."

Mr. Miller was, and is, undoubtedly familiar with the fact that bank confirmation requests are handled by bank personnel in a most routine fashion. How else could even a relatively small bank accomodate the enormous volume of such requests, especially as they proliferate at year end? As is evident from the standard confirmation form provided by the American Institute of CPAs (Exhibit B) mere numbers are the vogue -- numbers culled from the bank's computerized databank. As an auditor I cannot conceive of any bank having the confirmation requests presented to a consortium of its executives for them to provide a qualitative response. It may well be that I might have expected such a response a half century ago; it may be that some family bank somewhere might still do just that (in which event the ledger pages would be maintained with a quill pen). In any event, I am confident such banks are not those with which E.F. Hutton would do business.

Mr. Miller is presumed to have had the bank reconcilations for these hundred banks before him;* he undoubtedly there saw full blown the enormous amounts of incestuous checks floating about. This should have told him that E.F. Hutton was not "taking advantage of the float." Far from it -- his client was blowing up waves of fake balances on which it was floating -- and thereby creating those balances to be used for generating ill-gotten gains.

Did not all this raise a threshold question for AA's engagement partner, i.e., whether the client was in violation of the Foreign Corrupt Practices Act of 1977? Should not this question, at the very least, have been put to AA's counsel, i.e., not Hutton's management and/or its counsel?

I have cited it frequently in many contexts; I believe it needs to be re-cited here. I am alluding to the Chief Justice's inspired rhetoric in the Supreme Court's unanimous decision in U.S. v. Arthur Young & Co., ___ U.S. __; 104 S. Ct. 1495 (1984), at _______:

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* I am not familiar with AA's work paper filing procedures; nonetheless, I presume that the hundred, or so, bank confirmation forms reviewed by Mr. Miller were closely identified with the related bank reconciliations.

> Corporate financial statements are one of the primary sources of information available to guide the decisions of the investing public. In an effort to control the accuracy of the financial data available to investors in the securities markets the Securities and Exchange Commission regulations stipulate that financial reports must be audited by an independent certified public accountant.
>
> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This public watchdog function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.
>
> The SEC requires the filing of audited financial statements thereby encouraging public investment in the nation's industries. It is not enough that financial statements be accurate; the public must also perceive them as being accurate. Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional. [The auditor is not] an advocate for the client. If investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost. [Some ellipsis and citations omitted.]

It is by this standard that Arthur Andersen, et al., should govern their course of conduct as the independent auditors of publicly-owned entities.

By way of a "postscript" to this segment, Exhibit C (AA Interoffice Communication dated December 13, 1982) makes clear that even if AA may have felt confident with the unwritten legal opinion from Hutton's house counsel in early 1980, that confidence should have been much shaken by the developments during the ensuing two years. Messrs. Schneiderman and Rae went on to state that Hutton is not regulated by the Fed or the New York State Banking Regulators and that this was more of a banking issue. They stated, however, that it was possible the SEC could have been notified of such occurrences. The major concern of management was potential negative publicity if the media were informed.

Concerning the financial statements, based upon our discussion, we concluded that no disclosure was warranted as promulgated by FASB Statement No. 5 and that the financial statements have a liability caption entitled "Drafts & Checks Payable", which is far in excess of the asset "cash". This clearly illustrates the fact that checks have been written for amounts in excess of bank balances. This very topic was addressed in our 1979 examination where we concluded, after conferring with Tom Rae, that an entity does not have a legal problem with such a "drawdown" or transfer procedure as long as it has the intention and means to make payments as EFH has done in the past. Additionally, Tom Rae stated that as a result of the aforementioned transaction, no customer of Hutton was disadvantaged. Messrs. Lynch, Rae, Schechter, and Schneiderman were of the opinion that there were no claims asserted or unasserted, that EFH would suffer no financial loss, and that the only exposure might be unfavorable publicity. Even if Mr. Miller determined to ignore the "amber warning lights" discerned during the 1979 audit, the signals were "stridently red" two years later.

III

Regarding AA's Failure to Fulfill Its Responsibilities to E.F. Hutton's Audit Committee

For the purposes of this supplemental presentation to your Committee I shall take as my point of departure two of the memoranda first made available during the course of AA's testimony at the October 3 Hearings. These memoranda are included herewith as Exhibits D and E, representing: D: AA Interoffice Communication dated December 13, 1982, E: E.F. Hutton memorandum dated April 4, 1983.

Each of these two memoranda refers to ostensible meetings with the independent audit committee of Hutton's Board of Directors. Especially noteworthy are the following extracts:

From the December 13, 1982 memoradum:

> A telephonic meeting of the E.F. Hutton Group Inc. Audit Committee was held on December 10, 1982. Present in attendance were several members of Hutton senior management, including Thomas Lynch, Norman Epstein, Paul Hines and Thomas Rae. Attending via conference call were the members of the Committee: Edward Cazier, Warren Law and Bud Crary.* Joel Miller and John Tesoro represented AA & Co. (sic!)

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* Mr. Crary's name is not included on the roster of E.F. Hutton's audit committee, nor of its board of directors. He is, however, a major shareholder of the corporation.

. . . . .

He also discussed current legal matters, including the Harrisburg, Pennsylvania, check kiting investigation, stating that two postal inspectors had reviewed AA & Co.'s workpapers for the 1980 and 1981 audits.

From the April 4, 1983 memorandum:

A telephonic Audit Committee meeting was held on Thursday, March 24th, from 4:30 P.M. to 5:30 P.M.

Those attending were Tom Lynch and Mike Castellano from Corporate Headquarters, Joel Miller and John Tesoro from Arthur Andersen & Co., Warren Law and Edward Cazier from the Audit Committee and Bud Crary.

The topics discussed were as follows:

Bud Crary asked why the Pennsylvania District Attorney investigation on our use of over-drafting procedures was not mentioned in the 10-K. Tom Lynch stated we did not feel it was material. It did not have a material effect on our reduction of interest and Arthur Young performed a special review to which they concluded that what we were doing was perfectly correct and legal and that there was no need to indicate it in the Annual Report or 10-K.

I find this performance by the Arthur Andersen people incomprehensible and in patent violation of what might be presumed to be self-evident standards for meetings with an independent audit committee for the purpose of discussing the auditor's misgivings regarding management's conduct in a most sensitive area.

First, note that these two crucial meetings were "telephonic." This very circumstance raises serious questions, including:

- How could the committee observe any "body language" emanating from the auditor or management participants?
- Were there any "hand signals" passed between or among those who were congregated in the Hutton offices?
- How could the committee go into an executive session to reflect on the matters at hand?

- Were there agendas provided to the committee in advance of the "meetings" to permit the members to familarize themselves with the issues to be considered?

Putting all these logistical aspects aside, how could the Arthur Andersen people even consider a meeting with the committee on this most sensitive issue in the "presence" of the very management which was being challenged? Again, even a modicum of an awareness of the notion of checks and balances would have made abundantly clear that these telephonic meetings were absolutely improper.

Included herewith as Exhibit F is a 1978 AA monograph entitled "The Audit Committee of the Board of Directors." I have reviewed that document and maintain that there is an invidious distinction between the precepts advanced by AA in its publication, and the implementation thereof by its Hutton auditors. To the extent Arthur Andersen & Co. intended its publication to serve as a proselytizing medium (not necessarily to be applied in practice) then, I would brand the publication as "false and misleading advertising."

Further, I am confident that neither the Arthur Andersen nor E.F. Hutton people involved require the guidance of a 1979 Conference Board Report on The Audit Committee. (Significantly, both entities are so called "corporate members" of the Board.) Nonetheless, to round out this submission I am including as Exhibit G a collage of pages culled from that document. All this to point "a finger of shame" at the Arthur Andersen people for their having contributed to the cuckolding of E.F. Hutton's audit committee.

By way of tangential observations:

a. I note that at both of these meetings committee member Nadina Robertson was "included out" and, as noted, a "Bud Crary" is "included in".

b. Were these the only meetings of the auditors with the committee?

c. I take critical issue with AA's view that Financial Accounting Standards Board Statement of Financial Accounting Standard No. 5, "contingencies," 1975, obviated the need for disclosing the questionable practices discerned by the auditors. I maintain that the apparent violations of the Foreign Corrupt Practices Act, and the expressed anxious concern regarding public exposure made the contingency both material and overt.*

IV
Nor Do I Absolve the Audit Committee

Nothing in the foregoing discourse should be taken as an exculpation of Hutton's independent audit committee. Thus, an attorney and a professor of finance should have been fully cognizant of their responsibilities when they accepted their directorships and committee memberships. Surely, they should not have presumed that the amounts paid them for these undertakings were honoraria for permitting the corporation to add their names to the "totem pole."

They should have been especially aware of their extraordinary burdens in view of the fact that the three committee members were the only ones not overtly part of the management complex.

It would, of course, have been helpful to my analysis if your Committee's schedule had permitted the public testimony from the members of the audit committee. So it is that my critical analysis is related essentially to the interface of the independent auditors and the committee.

---

* It is noteworthy that Arthur Andersen & Co. used the same "Accounting Catch-22" to justify its determination to avoid charging General Dynamics' 1976 and 1977 income accounts with the hundreds of millions of dollars of losses which were festering on the corporation's 688 submarine contract.

See, in this connection, the extensive consideration of this issue in my testimony before the Joint Economic Committee, June 28, 1985, "Submerging and Camouflaging General Dynamics' Submarine Losses."

V
Conclusion

As noted at the outset I do not know whether this statement is timely for inclusion in the Record of the Hearings of your Committee. In any event I set forth these views as a part of what I consider to be the fulfillment of my undertaking to testify.

Should you require anything further in connection with this matter please advise.

Sincerely,

Abraham J. Briloff
Emanuel Saxe Distinguished
Professor of Accountancy

best copy available

[illegible] ANDERSEN NEW YORK NO.

Files

NEW YORK OFFICE

MARCH 7, 1980

EXHIBIT A

MEMORANDUM FOR THE FILES

RE: E.F. HUTTON MONEY MANAGEMENT PROCEDURES

On March 5, 1980, representatives of AA&Co. and E.F. Hutton met to discuss the client's procedures in the area of money management. Present in attendance were Joel Miller, Louis Flynn, Pat Gallagher, John [illegible] and Ted Chambers of AA&Co. and Thomas Rae, Michael Castellano and Larry Volpe of E.F. Hutton. The meeting was conducted by William Sullivan, Hutton's "Money Mobilizer." The purpose of the meeting was to obtain a greater understanding of the client's cash management procedures, whereby efforts are made by the firm to pay down bank loans and, thus, reduce interest expense. In addition, the meeting was also intended to discuss the company procedure of writing checks even though the balance per books is zero or negative. This is particularly relevant in light of the recent [illegible] Industries lawsuit where the firm was found criminally at fault for writing checks in excess of book and bank balances.

Bill Sullivan explained Hutton's procedure with eleven different banks (client is presently exploring the possibility of using five more banks) where checks are drawn on these banks even though the balance per book would not cover the amount of the checks. Mr. Sullivan pointed out that in each of these banks Hutton has deposited CEA funds which, even though they are legally segregated and cannot be used by the bank to cover shortages in Hutton's "general account", are treated as "offsets" by the banks under a "global approach" which allows Hutton to overdraw its balances. In addition, Hutton has put up as collateral available customer securities & DTC as "cover" the various banks' uncollected funds. These funds result in deposits made by Hutton via check which have not cleared (normal clearing period is one day).

Similarly, the company also has a "checks payable" or "zero balance checking" agreement with the Bank of America for payment to vendors and for issuing dividend payments to customer. Under this agreement, the Company writes checks overdrawing book balances, but maintains a zero or small deposit balance with the bank. This procedure is possible, according to William Sullivan, because the bank, each business day at 1:00 P.M., notifies the Company as to the required federal funds deposit to cover checks clearing the bank that day. The bank does not require any collateral for this particular arrangement.

The client maintains that the key to engaging in such transactions is that Hutton has the "means" to make ultimate payment. In other words, in the normal course of business the settlement of transactions will result in actual

A.A.&CO.
FORM [illegible] (REV. [illegible])
Printed in U.S.A.

INTEROFFICE COMMUNICATION

MEMORANDUM FOR THE FILES -2- MARCH 7, 1980

RE: E.F. HUTTON MONEY MANAGEMENT PROCEDURES

cash balances being deposited in the banks and, as a result, the balances per bank are rarely, if ever, overdrawn. Mr. Rae stated that the fact that Hutton has these "means" to pay, precludes any possible illegalities in processing these transactions. Mr. Sullivan further pointed out that Hutton has always been "above board" in its dealings with the banks and that the banks are fully aware of the nature of these transactions (i.e., drawing checks on the account even though Hutton's records do not reflect a book cash balance large enough to cover the check at the time it is drawn). He also stated that several banks (Chase Manhattan, for example) have requested Hutton actually increase the scope of these activities.

After the discussion of the procedures employed and their legality, Joel Miller, AA&Co. engagement partner, requested that Tom Rae render a written legal opinion stating that Hutton's activities in this area don't present any potential legal problems. Mr. Rae declined to render such an opinion, stating that the banks are fully cognizant of Hutton's procedures, that this is an accepted banking practice and that there is no question as to the propriety of such transaction, again making reference to the "means of payment" principles. After Tom Rae declined to issue an opinion on this matter, Bill Sullivan offerend to call one of the banks Hutton uses, Morgan Guaranty, and ask them what the banks would do if a company were to issue checks with no book balances (i.e., such as Hutton's segregated commodity balances). Joel Miller then stated that he would discuss the matter with other partners at AA&Co. whose clients include major money center banks to ascertain what the bank's "point of view" is regarding these transactions.

LOUIS T. LYNN
JOHN TESORO

gmb

EXHIBIT 3

STANDARD BANK CONFIRMATION INQU
Approved 1966 by
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACC
and
BANK ADMINISTRATION INSTITUTE (FORMERLY NABAC)

________________ 19____

Your completion of the following report will be sincerely appreciated. IF THE ANSWER TO ANY ITEM IS "NONE," PLEASE SO STATE. Kindly mail it in the enclosed stamped, addressed envelope direct to the accountant named below.

Report from

Yours truly, ______________________________
(ACCOUNT NAME PER BANK RECORDS)

By ______________________________
Authorized Signature

(Bank) ______________________________
____
____

Bank customer should check here if confirmation of bank balances only (item 1) is desired. ☐

NOTE—If the space provided is inadequate, please enter totals hereon and attach a statement giving full details as called for by the columnar headings below.

Accountant

1. At the close of business on ________________ 19____ our records showed the following balance(s) to the credit of the above named customer. In the event that we could readily ascertain whether there were any balances to the credit of the customer not designated in this request, the appropriate information is given below.

AMOUNT	ACCOUNT NAME	ACCOUNT NUMBER	Subject to Withdrawal by Check?	Interest Bearing? Give Rate
$				

2. The customer was directly liable to us in respect of loans, acceptances, etc., at the close of business on that date in the total amount of $____________ as follows:

AMOUNT	DATE OF LOAN OR DISCOUNT	DUE DATE	INTEREST		DESCRIPTION OF LIABILITY, COLLATERAL, SECURITY INTERESTS, LIENS, ENDORSERS, ETC.
			Rate	Paid to	
$					

3. The customer was contingently liable as endorser of notes discounted and/or as guarantor at the close of business on that date in the total amount of $____________ as below:

AMOUNT	NAME OF MAKER	DATE OF NOTE	DUE DATE	REMARKS
$				

4. Other direct or contingent liabilities, open letters of credit, and relative collateral, were
____

5. Security agreements under the Uniform Commercial Code or any other agreements providing for restrictions, not noted above, were as follows (if officially recorded, indicate date and office in which filed):
____
____

Yours truly, (Bank) ______________________________

By ______________________________
Authorized Signature

Date ________________ 19____

Additional copies of this form are available from the American Institute of CPAs, 1211 Avenue of the Americas, New York, N.Y. 10036

#1 INTEROFFICE COMMUNICA

EXHIBIT C

[redacted]

NEW YORK OFFICE F. L.

FEBRUARY 25, 1982

STRICTLY CONFIDENTIAL

MEMORANDUM FOR THE FILES

SUBJECT: TRANSFERS OF FUNDS

On February 25, 1982, Joel Miller and John Tesoro met with Tom Lynch (Executive V.P.), Tom Rae (Executive V.P., Legal) and Loren Schechter (Senior V.P., Legal) as well as Irwin Schneiderman of Cahill, Gordon & Reindel to discuss a situation concerning Hutton's policy of transferring cash balances between banks as well as "drawing down" cash from Hutton's branches to regional headquarters and finally to New York. It was brought to the attention of Hutton management that checks written on a bank in upstate New York had "bounced" as a result of "drawing down" balances for which subsequent deposits had not been made by the time such checks cleared. In addition, it was also brought to Hutton's attention by the New York State Banking Regulators that a significant amount of transfers took place between Manufacturers Hanover Trust and Chemical Bank in late December and January.

Concerning the first issue, Tom Rae stated that overdraft situations at the local bank should never have occurred and that the personnel responsible have been notified as to Company policy concerning drawdown procedures at the local bank level. Mr. Rae stated that the bank involved desires to continue doing business with EFH and did not seek to charge Hutton interest on the overdrawn balances (in answer to Joel Miller's question).

As far as the second issue is concerned, the Banking Regulators and the Federal Reserve Board expressed concern over the controls of Manufacturers Hanover concerning transferring of large balances when, in fact, there may not be sufficient funds to cover these transfers (i.e. from a credit risk point of view). Additionally, the Fed also apparently expressed concern over "creating float" as opposed to taking advantage of the float inherent in the banking system. We were assured of the fact that no action has been brought against Hutton nor unasserted claims, and in fact, the banks have not "lost" in the sense that EFH leaves money on deposit in the normal course of business (albeit not formal compensating balance arrangements).

Messrs. Schneiderman and Rae went on to state that Hutton is not regulated by the Fed or the New York State Banking Regulators and that this was more of a banking issue. They stated, however, that it was possible the SEC could have been notified of such occurrences. The major concern of management was potential negative publicity if the media were informed.

INTEROFFICE COMMUNICATION

MEMORANDUM FOR THE FILES - 2 - FEBRUARY 25, 1982

Concerning the financial statements, based upon our discussion, we concluded that no disclosure was warranted as promulgated by FASB Statement No. 5 and that the financial statements have a liability caption entitled "Drafts & Checks Payable", which is far in excess of the asset "cash". This clearly illustrates the fact that checks have been written for amounts in excess of bank balances. This very topic was addressed in our 1979 examination where we concluded, after conferring with Tom Rae, that an entity does not have a legal problem with such a "drawdown" or transfer procedure as long as it has the intention and means to make payment as EFH has done in the past. Additionally, Tom Rae stated that as a result of the aforementioned transaction, no customer of Hutton was disadvantaged. Messrs. Lynch, Rae, Schechter, and Schneiderman were of the opinion that there were no claims asserted or unasserted, that EFH would suffer no financial loss, and that the only exposure might be unfavorable publicity.

John M. Tesoro
JOHN M. TESORO

J. E. Miller
JOEL E. MILLER

LL

#2

INTEROFFICE COMMUNICATI

EXHIBIT D

NEW YORK OFFICE

DECEMBER 13, 1982

MEMORANDUM TO THE FILES

SUBJECT: AUDIT COMMITTEE MEETING, DECEMBER 10, 1982

A telephonic meeting of The E.F. Hutton Group Inc. Audit Committee was held on December 10, 1982. Present in attendance were several members of Hutton senior management, including Thomas Lynch, Norman Epstein, Paul Hines and Thomas Rae. Attending via conference call were the members of the Committee: Edward Cazier, Warren Law and Bud Crary. Joel Miller and John Tesoro represented AA&Co.

INTEROFFICE COMMUNICATION

MEMORANDUM TO THE FILES -2- DECEMBER 13, 1982

SUBJECT: AUDIT COMMITTEE MEETING, DECEMBER 10, 1982

Professional Education Department. He also discussed current legal matters, including the Harrisburg, Pennsylvania, check kiting investigation, stating that two postal inspectors had reviewed AA&Co.'s workpapers for the 1980 and 1981 audits.

JOHN M. TESORO

LL

Attachment

#4

EXHIBIT B

TO The File
FROM Michael P. Castellano
DATE April 4, 1983
SUBJECT Audit Committee Meeting

✓ G/C FILE

A telephonic Audit Committee meeting was held on Thursday, March 24th, from 4:30 P.M. to 5:30 P.M.

Those attending were Tom Lynch and Mike Castellano from Corporate Headquarters, Joel Miller and John Tesoro from Arthur Andersen & Co., Warren Law and Edward Cazier from the Audit Committee and Bud Crary.

The topics discussed were as follows:

6. Bud Crary asked why the Pennsylvania District Attorney investigation on our use of over-drafting procedures was not mentioned in the 10-K. Tom Lynch stated we did not feel it was material. It did not have a material effect on our reduction of interest and Arthur Young performed a special review to which they concluded that what we were doing was perfectly correct and legal and that there was no need to indicate it in the Annual Report or 10-K.

M Castellano

MC:jr

Audit Committee Members:
E. Cazier
W. Law
N. Robertson

cc: B. Crary
P. Hines
T. Lynch
J. Miller (AA & Co.)
J. Tesoro (AA & Co.)

EXHIBIT F

The Audit Committee of the Board of Directors

Trends, Status and Views on a Concept of Growing Interest

Emergence of the Audit Committee

An increasing number of American business executives are coming to the tardy realization that, as the fairy tale princes of Serendip found, accidental discoveries sometimes yield unexpected benefits. In this case, the bonus is a degree of reassurance for corporate directors. And the vehicle of discovery is the corporate audit committee.

Spurred by a rising tide of shareholder litigation, disclosures of illegal or questionable payments by more than 400 American corporations and an increasingly active Securities and Exchange Commission, corporate directors lately have developed a new appreciation of the audit committee.

Thanks in large measure to a New York Stock Exchange requirement that each Big Board company have an active audit committee by June 30, 1978, such committees are gaining increasing acceptance.

In 1972, we published a brochure advocating the establishment of audit committees to assist corporate boards in discharging their responsibilities—particularly those relating to the quality of financial reporting. Subsequent events have significantly altered the sociopolitical environment in which business operates, heightening interest in, and elevating the status of, such committees.

We believe this is an appropriate time to take a second look at the corporate audit committee and reconsider its responsibilities. We also believe the time is now ripe for establishing such committees to serve certain privately held companies as well as a wide range of other organizations with a public constituency—hospitals, universities and the like.

While nearly six years have passed since our first publication on audit committees, our initial reasons for favoring the establishment of such committees seem as relevant now as they did then. As we stated in 1972:

- ☐ "Directors have a responsibility for monitoring the company's financial reporting.
- ☐ "Directors have been held liable for failure to discharge their responsibilities for financial reporting.
- ☐ "Financial reporting has become increasingly complex and at the same time the public has a growing awareness of its deficiencies.
- ☐ "The independent auditors are responsible to the stockholders, yet their day-to-day contact is with management.
- ☐ "The independent auditors and directors can best discharge their responsibilities to the stockholders for financial reporting by having a dialog concerning all aspects of the business as it relates to such reporting.
- ☐ "A committee approach is often a more efficient method of operation than full board participation."

This brochure provides an updated description of the organization and operations of audit committees.

Advocates of the Audit Committee Concept

From the beginning, the principal advocates of audit committees have been those outside the corporate world. The accounting profession, the Securities and Exchange Commission (SEC), and the New York Stock Exchange (NYSE) have endorsed the establishment of audit committees for several years. Recently, Congress has joined the chorus.

Accounting Profession

The Executive Committee of the American Institute of Certified Public Accountants (AICPA) in 1967 recommended the appointment of committees composed of outside directors to nominate the independent auditors and review their work. At the same time, the AICPA noted that such committees "can be a constructive force in the overall review of internal controls and financial structure, (can) give added assurance . . . (of) the objectivity of corporate financial statements . . . , can assist their full boards of directors in matters involving financial statements and control over financial operations . . . , (and) can also strengthen the position of managements by providing assurance that all possible steps have been taken to provide independent review of the managements' financial policies and operations. This is good for the company and good for the public."

The AICPA board of directors recommended in July 1977 that all AICPA members in public practice encourage their clients to establish audit committees. More recently, the AICPA appointed a committee to study whether it should adopt an ethical or auditing standard prohibiting public accountants from accepting audit engagements from publicly owned companies that do not have an audit committee composed of outside directors.

In February 1978, the Commission on Auditors' Responsibilities, an independent AICPA study group, reported its conclusions and recommendations on the responsibilities of auditors. Commenting on the importance of the auditor's independence from management, that report said:

> "The board of directors, with outside members and an audit committee when appropriate, is the best vehicle for achieving and maintaining balance in the relationship between the independent auditor and management. Therefore, the Commission believes that steps should be taken by boards, auditors, and when necessary, by regulatory authorities to help assure that boards will actively exercise this opportunity. Where appropriate to the size and circumstances of the corporation, board membership should include independent outsiders, and an audit committee should be formed. Audit committees, however, cannot function effectively unless they include competent, independent, and reasonably active outside members of the board. The important point is that the auditor should have direct access to a significant number of board members who are not part of management. Outside members of the board of directors are in a unique position to represent the shareholders' interest, to monitor the performance of management, to provide adequate support to the independent auditor, and to make changes within the organization."

The report also suggested that outside directors "should be responsible for recommending to shareholders the appointment of independent auditors and for evaluating the relationship between the auditor and management."

Securities and Exchange Commission

The SEC in 1972 endorsed (ASR No. 123) the establishment of audit committees composed of outside directors by all publicly held companies. Two years later, the SEC adopted rule changes requiring corporations to disclose in proxy material the names of audit committee members or, to highlight its absence, to state if the corporation has no such committee.

In 1976, the SEC again underscored its interest in audit committees, this time as a means of deterring questionable and illegal corporate payments and other practices. In its report to the Senate on "Questionable and Illegal Corporate Payments and Practices," the Commission wrote:

> "Actions to further enhance the creation by public corporations of audit committees composed of independent directors to work with

outside auditors would . . . serve as a valuable adjunct to these legislative proposals. . . .

"The importance of the role of the board of directors, independent audit committees, and independent counsel has been illustrated by the Commission's enforcement actions in the area of questionable or illegal corporate payments. Significantly, in some of these cases no audit committee existed. In others, with a single exception, audit committees either operated only during a portion of the time when the questionable payments were alleged to have been made, or were not wholly independent of management. Accordingly, the resolution of these proceedings typically has involved establishment of a committee comprised of independent members of the Board of Directors, charged to conduct a full investigation, utilizing independent legal counsel and outside auditors to conduct the necessary detailed inquiries.

"The thoroughness and vigor with which these committees have conducted their investigations demonstrate the importance of enhancing the role of the board of directors, establishing entirely independent audit committees as permanent, rather than extraordinary, corporate organs and encouraging the board to rely on independent counsel."

Acting "to further strengthen the independence of auditors," the SEC, in September 1977, proposed a rule to require disclosure in a company's proxy material of audit fees and services and approval thereof by the board of directors or its audit committee. The text of the proposal included the following comments:

> "It is desirable for all public companies to have audit committees composed of independent directors *and ways are being considered by which such committees might be encouraged or required* (emphasis added).
>
> "The Commission believes that objectivity and independence are enhanced if the auditor deals with an audit committee of independent directors or the board of directors in determining services and fees. In order to provide investors with knowledge of whether the board of directors or audit committee has approved all services provided by the auditors, the Commission proposes to require disclosure of whether such approval has taken place."

New York Stock Exchange

In 1973, the NYSE strongly recommended that each listed company form an audit committee, preferably composed exclusively of outside directors, and noted that these directors can "aid the other directors in fulfilling their responsibilities to the public, enhance the corporate image and provide improved communication with the outside auditor." The Exchange observed that an audit committee "no longer represents a corporate luxury but has become a necessity."

Then, in January 1977, the NYSE adopted a resolution *requiring* that an audit committee, comprised solely of independent directors, be established no later than June 30, 1978. This requirement is now a condition for listing of companies new to the NYSE and a condition for continued listing of present Big Board companies.

Congress

While the accounting profession, the SEC and the NYSE have advocated the audit committee concept for years, Congress has only recently expressed its interest in the matter. In its 1976 report on an investigation of the SEC, for instance, the House Subcommittee on Oversight and Investigations (the Moss Committee) criticized boards of directors' performance in general and specifically noted the desirability of audit committees.

Given this new interest on the part of Congress, a possibility looms that new legislation may require boards of directors of all publicly held companies to establish and maintain audit committees. The principal concern is that, once the Congressional camel gets its nose in the corporate tent, such legislation could conceivably go on to establish specific rules and regulations governing the responsibilities and performance of audit committees and boards of directors in general.

Views of Arthur Andersen & Co.

Testifying on May 24, 1977 before the Senate Subcommittee on Reports, Accounting and Management, Harvey Kapnick, Chairman of Arthur Andersen & Co., discussed the role of the corporate audit committee. We believe his views are particularly relevant and warrant thorough consideration.

Mr. Kapnick expressed our firm's views on various issues relative to sound financial reporting and the maintenance of both the integrity of independent auditors and public confidence in their work. He stressed that "a strong board of directors, with an audit committee of independent outside directors, is essential in today's corporate environment."

He said, "The audit committee should perform various functions relating to the company's financial statements and the independent auditors, such as the following:

☐ "Recommend to the board of directors the independent auditors to be selected.

☐ "Discuss with the independent auditors the scope of their audit and the related fees.

☐ "Discuss with the independent auditors and management the company's accounting principles and policies and the reporting practices followed, including the impact of alternative accounting principles.

☐ "Discuss with the internal auditors the adequacy of the company's accounting and financial systems and internal controls.

☐ "Be aware of all work (audit, tax, and systems) that the public accounting firm performs for the company.

☐ "Review, understand the reasons for, and approve any significant increase in the scope of audit work.

☐ "Discuss with the independent auditors the results of their audit, along with any matters of controversy (resolved or unresolved) with management.

☐ "Review and determine what action is required as a result of a memorandum prepared by the independent auditors listing significant weaknesses in internal control noted during the annual audit and management's evaluation of such weaknesses. The audit committee should determine appropriate action on the basis of its cost/benefit evaluation.

☐ "Review a memorandum prepared by the independent auditors setting forth any questionable or possibly illegal activities or payments noted during their audit work. It should be recognized that the auditor is not a lawyer and, in many instances, will not know whether a particular activity or payment is improper or illegal. Therefore, the audit committee should seek the advice of legal counsel and take appropriate action on such items."

Mr. Kapnick also expressed the view that "the AICPA should promulgate a professional standard, either auditing or ethical, establishing as a condition for accepting an audit engagement for a publicly owned company, that an audit committee of outside directors be established. We believe this approach would be much better than a Federal law or regulation requiring audit committees. Such a Federal requirement would inevitably lead to further laws and regulations concerning the duties and responsibilities of directors and other corporate matters." As indicated earlier, an AICPA committee is now studying this issue.

How to Set Up the Audit Committee

Audit committees should be established by a resolution of the company's board of directors. In addition to approving the creation of the committee, the board resolution may cover such matters as:

- ☐ Committee objectives and responsibilities.
- ☐ Qualifications for membership.
- ☐ Term of committee appointment.
- ☐ Number and types of meetings to be held annually.

Audit Committee Objectives and Responsibilities

Since the corporate audit committee still is in a very early stage of evolution, the better part of wisdom is to define the committee's duties and responsibilities in broad nonrestrictive terms. This will allow sufficient flexibility for the committee to adapt to changing circumstances.

A committee's specific objectives will vary depending on a company's facts and circumstances, but here are two broad goals that normally will encompass all relevant matters:

- ☐ Establish and maintain continuing communications between the board and the company's independent auditors, internal auditors (if any), and members of financial management with respect to such matters as:
  - ☐ Annual and (when applicable) interim financial statements.
  - ☐ Scope and results of the annual audit and the related fees.
  - ☐ The company's accounting and financial reporting practices.
  - ☐ Adequacy and effectiveness of the system of internal accounting controls.
  - ☐ Scope of other services performed by the independent auditors.
  - ☐ Any other matters relative to the audit of the company's accounts and its financial affairs that the committee, in its own discretion, deems necessary.
- ☐ Recommend the retention and, when necessary, the termination and replacement of the independent auditors.

Qualifications for Membership

Committees composed entirely of outside directors provide the best assurance of objectivity and independence and are preferable. At a minimum, however, the *majority* of committee members should be outside directors. Many believe an officer-director serving on the audit committee cannot be impartial in reviewing decisions that he or she may have made or participated in making. As noted earlier, the NYSE prohibits any officer or employee of a company listed on the Big Board from serving on the audit committee.

Broad business experience, openmindedness and good judgment are necessary characteristics of an audit committee member. An accounting and financial background is not absolutely necessary, although some knowledge of financial reporting is desirable. If at all possible, at least one member should be financially oriented and have specific knowledge of accounting principles and financial reporting practices.

Term of Membership

Terms of membership can range from one year to an indefinite period with removal at the request of the member or recommendation of the board. No single approach will suit all needs.

Recent statistics reveal that most committee members serve one-year terms, although terms generally are extended to capitalize on the experience gained in working on the committee. Some companies stagger the terms of membership based on the number of committee members. For instance, a three-member committee might be composed of members appointed for three-year terms with one member selected each year. Under this approach, the member serving his or her last year often serves as chairman.

Some believe the practice of rotating some, but not all, audit committee members each year provides continuity within the committee and, at the same time, permits all outside directors to become familiar with the financial operations and audit function. This approach also brings a fresh approach to the committee each year. A limiting factor to the composition of the audit committee is, of course, the number of directors eligible and qualified to serve.

Number and Types of Meetings

The committee itself should determine the number and timing of its meetings. The frequency of meetings will depend, to a considerable extent, on the committee's overall responsibilities and the number and significance of the matters it must deal with. Most audit committees meet with the independent auditors and financial management at least twice a year.

The purpose of the first meeting with the independent auditors usually is to discuss the general scope of the audit and estimated audit fees, major anticipated audit problems, the company's more significant accounting policies and reporting practices, and any recent changes in such policies and practices. This initial meeting also deals typically with a review of recent developments in accounting principles or reporting practices (e.g., recent pronouncements of the Financial Accounting Standards Board or SEC) that may affect the company or the scope of the audit.

The initial meeting also may include a review of the company's financial affairs and related matters with the chief financial officer and a discussion of activities and plans for the coming year with the company's internal auditor. Such a meeting also may be an appropriate time to cover with the auditors and management the changes, if any, in the company's system of internal accounting controls.

The final meeting of the year with management and the independent auditors would be to review results of the audit, the financial statements, the auditors' report, and any suggestions for improvements in accounting procedures and internal accounting controls developed during the audit examination. The committee also should question the independent auditors about any other services (e.g., tax, systems) rendered during the past year and the results of such work and related fees.

Additional meetings should be held as circumstances warrant. Some audit committees meet with the independent auditors after completion of the preliminary audit work. Some committees also prefer to consider the auditors' recommendations for improvements in accounting procedures and internal accounting controls in a separate meeting after completion of the audit. In addition, the occurrence of unanticipated events that have a significant impact on the company's financial statements or the scope of the audit may warrant a special audit committee meeting.

Among the matters an audit committee may wish to consider in special meetings are:

- Significant and unusual transactions or events presented (or to be presented) in interim reports and press releases.
- Recent accounting, reporting and auditing proposals promulgated by regulatory or professional bodies that would have a significant impact on the company.
- Proposed changes in accounting policies and their effect on the company's financial reporting.
- Special investigations of political contributions, conflicts of interest, and compliance with Federal, state and local laws and regulations.

Meetings often are scheduled just prior to board meetings so the committee can give the board a timely report on its activities. Advance distribution of an agenda and appropriate background material generally improves the effectiveness of committee meetings. Advance study of the agenda and related material helps members prepare questions in advance and develop a basic line of inquiry.

It is common to excuse management participants from a portion of the meeting so that committee members can question the auditors where they believe the discussion might be inhibited if members of management were present.

Minutes should be prepared for each meeting and maintained as a permanent part of the corporate records.

Principal Functions of Audit Committees

Selection, Retention or Termination of Independent Auditors

One of the audit committee's most important functions is its recommendation to the board of directors or shareholders on the retention of the company's independent auditors or, when circumstances warrant, selection of a new auditing firm. Clearly establishing that the independent auditors cannot be terminated or replaced without the concurrence of the audit committee dispels any question of the auditors' ability to disagree with management. This is a significant benefit—it underscores the fact that the auditors are in fact independent of management, that the auditors work for the shareholders, not management, and that both the independent auditors and management are subject to effective oversight.

The audit committee should evaluate the independent auditors' performance *annually* and, if satisfied with the overall service, may properly recommend retaining the present auditors. In making this evaluation, audit committee members should consider not only their own personal contacts with the auditors but those of management as well.

Here are some questions committee members might consider in weighing the performance of the company's auditors or, for that matter, in evaluating other firms to replace the present auditors:

☐ *Do the auditors have enough knowledge of our industry to understand adequately our company's operations and special accounting and reporting problems? Have they applied this knowledge in establishing the scope of their audit and in developing recommendations to improve accounting procedures and internal controls?*

☐ *Have the auditors made substantive recommendations for improvements in accounting procedures and internal accounting controls or do they appear to dwell on insignificant matters?*

☐ *Did the auditors properly inform management and the audit committee of changes in accounting principles or reporting requirements instituted by the accounting profession and the SEC?*

☐ *Have the auditors responded promptly to management's and the committee's questions and requests for information during the year?*

☐ *Did the auditors offer recommendations or initiate discussion in the areas of tax planning and computer systems (e.g., was it management or the auditors who suggested the change from the FIFO to LIFO method of inventory costing last year)?*

☐ *Have the auditors developed and maintained the proper working relationship with management; i.e., does the relationship permit the auditors to discharge their audit responsibilities effectively without impairing their independence?*

☐ *What are the auditing firm's policies with regard to rotation of personnel on the audit engagement? Is it sufficient to bring a fresh viewpoint to the audit while providing appropriate continuity to maintain familiarity with our company's systems and operations?*

The audit committee also may wish to consider other factors in evaluating the present auditors or in selecting a replacement. For example, it may be appropriate to consider the firm's quality control and training practices, review financial and other operational data supplied by the firm, consider the size and location of its offices in relation to the company's operations (including its international operations), and inquire into the experience and availability of personnel specialized in such areas as international taxes, computer auditing and SEC matters.

If the committee feels the present independent auditors are not performing satisfactorily, it should recommend a change to the full board and be responsible for recommending a replacement. In selecting a new auditing firm, audit committees generally consider proposals by several accounting firms. Oral presentations offer committee members an opportunity to meet those who would be responsible for the audit engagement.

The most important persons on the audit team will be the engagement partner who will have prime responsibility for the audit, a second or advisory partner with whom the engagement partner may consult periodically, and the audit manager who will be responsible for day-to-day matters connected with the audit. The audit committee also may wish to meet some of the firm's specialists, such as the tax partner who would be assigned to the engagement.

When a change of auditors is recommended by management, the audit committee should normally meet with both management and the auditors to obtain their views concerning the proposed change. The purpose of such meetings is to pinpoint the reasons for the proposed change and to determine if there are any disagreements with respect to accounting principles and practices, auditing scope and procedures, or financial statement disclosures (reportable to the SEC) that could have a bearing on the company's financial statements and on its relationship with the new auditors.

Review of Scope of Audit and Related Fees

The scope of the audit, i.e., the nature, extent and timing of audit procedures to be applied, is the responsibility of the auditors and is established to enable them to express an opinion on the financial statements. (The auditors usually will set forth their understanding of the scope of services in an arrangement letter for review by the committee.) By reviewing and discussing with the auditors the intended scope of the examination, the committee will gain a better understanding of the work to be performed and will be better able to evaluate any changes made during the course of the work and the results of the audit. While the auditors alone can establish and are responsible for the necessary scope of the examination, the audit committee may wish to instruct them to perform certain specific procedures (e.g., review selected expense account reimbursements for each officer) or to visit certain specific locations above and beyond what is required to express an opinion on the financial statements.

A primary objective of this function is to ascertain that management has not restricted the proposed scope of the examination (or, if so, why) and that problem areas will be given proper consideration. It is appropriate for the committee to examine and approve the estimated fees for the audit and the basis on which such fees have been determined.

More specifically, the review may consist of obtaining an understanding of:

- ☐ *The independent auditors' responsibilities for the detection of errors and irregularities, including illegal acts.*
- ☐ *The annual financial reporting requirements of the company; for example, reports required to be filed with the SEC and other regulatory agencies, separate financial statements of subsidiaries required by loan agreements, statutory reporting provisions in foreign countries, and similar considerations.*
- ☐ *The extent of audit coverage of certain significant financial statement items, such as receivables and inventories, and the audit procedures used. For example, the committee might consider the extent to which receivables are circularized and physical inventories are observed, the manner in which possible inventory obsolescence is tested, and so on.*
- ☐ *In situations involving multilocation companies, the reasons for the auditors' selection of the locations to be visited and the system of rotation of audit visits from year to year.*
- ☐ *Areas of special concentration, such as problems that might result in other than an unqualified opinion on the financial statements; changes in accounting principles or practices; new or unusual conditions, events or transactions; and weaknesses in the existing system of internal accounting control that create a need for expanded substantive testing.*
- ☐ *The effect of any new pronouncements by the Financial Accounting Standards Board (FASB), AICPA or SEC on the scope of the examination; for example, the recent FASB pronouncement on segment reporting.*
- ☐ *The extent to which the internal audit function is utilized by the independent auditors to maximize overall audit coverage.*

Review of Financial Statements and Results of Audit

A major function of the audit committee is to review the company's financial statements and the audit results with management and the independent auditors.

Financial Statements

The level of review of the financial statements by the audit committee will depend on individual circumstances, but the principal objectives are to determine:

☐ *Whether the statements are presented fairly in conformity with generally accepted accounting principles.*

☐ *That proper consideration has been given to the accounting and disclosure treatment of any new or unusual transactions or events.*

☐ *That proper consideration has been given to the selection of accounting principles from among available alternatives (e.g., depreciation methods and inventory pricing practices).*

☐ *That management's decisions appear reasonable in significant areas of asset valuation and measurement of liabilities where judgment is a factor.*

☐ *How major financial reporting problems, if any, were resolved.*

In some situations, a general discussion with management and the independent auditors of the more significant financial statement captions and disclosures will suffice. In others, a detailed discussion and analysis of most financial statement items may be necessary. Since the preparation and content of the financial statements is a responsibility of management, the audit committee should focus its inquiry on management. In most cases, however, the committee probably will want the independent auditors also to participate in the review.

Here are some representative questions that committee members may ask management as part of a financial statement review:

☐ *How was the allowance for doubtful accounts determined? Did the auditors have any problems with this approach? Was the method used the same as in the preceding year? How does the allowance compare to the prior year and to the level of receivables? Have any of our businesses encountered significant collection problems this year? Why? Is a change in our credit and collection policies in order?*

☐ *Does the company have any significant amount of excess or obsolete inventories? What steps are taken by management to identify such problems on a timely basis? How are inventory reserve requirements calculated? Did the auditors concur with the method of calculation? Have there been any changes in this area since last year?*

☐ *What impact on the operating statement did use of the LIFO method of pricing inventories have this year? Is the method of calculating the LIFO reserve consistent with prior years? Have there been any liquidations of LIFO inventory pools during the year? If so, what was the impact of the liquidation on net income and is disclosure of that fact needed in the financial statements? Are there any risks with respect to the LIFO elections and calculations made by the company?*

☐ *On what bases were the company's reportable industry segments and geographic areas determined? Were alternative disaggregations considered by management or the independent auditors? Does the company have significant revenues from domestic or foreign government agencies that may require disclosure in the future?*

☐ *Were any product lines discontinued during the year? If so, what impact did this have on inventory valuation and the carrying value of the related equipment, tools and dies? Did the auditors agree with the determination of carrying values?*

☐ *In the case of subsidiaries that incurred operating losses this year, have we adequately considered realization of the subsidiaries' investment in plant and equipment? Inventories? Goodwill?*

☐ *With regard to any major loss contingencies facing the company* *(e.g., litigation, unasserted claims, tax assessments, etc.), how are these reflected in the financial statements? What is the basis for the conclusion that the outcome of such matters will result in no material cost to the company?*

- ☐ *How are unusual or infrequently occurring items (e.g., provision for settlement of a product-liability suit) reflected in the income statement? Should we present these as extraordinary items?*
- ☐ *To the extent that the company has amended any pension plans to conform to ERISA, increase benefits, or otherwise, how has this affected the pension provision and unfunded vested benefits? Were there any changes in the actuary's assumptions and, if so, what was the impact on the provision for the year? Should any of these changes be disclosed in the financial statements?*
- ☐ *How has the company accounted for acquisitions during the year? How are new investments in joint ventures, etc., reflected in the financial statements?*
- ☐ *How was earnings per share (EPS) calculated? What items are deemed to be common stock equivalents? What causes the difference between primary and fully diluted EPS?*
- ☐ *How did the auditors resolve potential problem areas discussed at earlier meetings (e.g., potential problems with respect to the warranty reserve because of the discovery of a defect in a major raw material component)? What was the impact, if any, on the financial statements?*
- ☐ *Through what year have the company's Federal income tax returns been examined by the Internal Revenue Service? Were there any significant disallowances? If so, did management adequately consider these disallowances in determining the provision for income taxes in the current year?*

Results of Audit

Concurrent with a review of the financial statements, the audit committee also should review results of the audit with the independent auditors. Among the principal matters for consideration by the committee are:

- ☐ *The auditors' report and, if applicable, the reports of other auditors.*
- ☐ *Any differences between the planned and actual scope of the audit not previously brought to the audit committee's attention.*
- ☐ *Resolution of major audit problems noted during earlier meetings.*
- ☐ *Any major differences between management and the independent auditors with respect to such matters as:*
  - *Accounting principles and practices.*
  - *Reporting of specific transactions or events.*
  - *Financial statement disclosures.*
  - *Proposed audit adjustments.*
- ☐ *The auditors' memorandum covering suggestions for improvements in accounting procedures and the company's system of internal accounting controls.*
- ☐ *The auditors' memorandum, if any, setting forth any questionable, or possibly illegal, activities or payments (including unsupported payments) noted during the audit.*
- ☐ *Any restrictions imposed by management on the auditors during the course of their examination.*
- ☐ *Opinion of auditors as to the technical competence of the company's financial and accounting management.*
- ☐ *Any variances in actual audit fees from original estimates and reasons for such variances.*

Examples of questions frequently asked by audit committees in reviewing the results of the audit include:

- ☐ *Did you receive complete cooperation from management? If not, in what respects was such cooperation lacking?*
- ☐ *Did the actual scope of the audit differ from preaudit plans? If so, why? What impact did this have on the audit fees?*
- ☐ *Were the reports of other auditors qualified in any respect? Why? Why isn't this mentioned in your report?*

☐ *How has management responded to your suggestions for improvements in the company's system of internal accounting control? Are there any serious weaknesses still not corrected? Are there any control techniques that could be modified or scrapped to eliminate duplication?*

☐ *What adjustments were proposed by you during the course of your work? What was the effect of adjustments recorded by the company on the annual financial statements? Those not recorded? Are these adjustments indicative of deficiencies in the company's annual or interim reporting system?*

☐ *How would you characterize our company's accounting policies in relation to others in our industry (e.g., how does our method of evaluating inventory obsolescence compare with industry practice)?*

☐ *Are there any accounting policies that management should consider changing? Why?*

☐ *Did you review the company's policies and procedures with respect to possible conflicts of interest, political contributions, bribes, kickbacks, etc.? How? What were the results of your review?*

☐ *Did the scope of your audit include a review of officers' expense reports? Are the company's procedures for approval of such expense reports adequate?*

☐ *Is the company making effective use of its computers?*

☐ *Does the company's internal audit function appear to be properly organized and staffed? Is it operating effectively? In what areas did the internal auditors assist you in this year's audit? Could their role be expanded next year?*

Review of Internal Control System

One audit committee function that has grown considerably in importance in recent years is the consideration of the company's system of internal accounting controls. This has stemmed from a number of developments, including a few widely publicized cases of so-called "computer fraud" and "sensitive payments."

As a consequence of the increased interest in this subject, Congress passed the Foreign Corrupt Practices Act of 1977, which requires publicly held companies, among other things, to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that certain specified objectives are met. The SEC also is considering whether to require some form of public reporting on the system of internal accounting controls.

Because of these developments, publicly owned companies should be conducting studies of their systems of internal accounting control,[1] and it would be appropriate for audit committees to review the results of such studies. Such a review would focus primarily on inquiries of the internal auditors, management, and the independent auditors. Following are examples of questions that may be directed to each of these parties:

Internal Auditors

☐ *Have you studied and evaluated the company's system of internal accounting controls? How and when was this review performed?*

☐ *Are company policies clearly defined and properly communicated to our personnel? In what areas could company policies be improved? How?*

☐ *Do you feel there are any areas of accounting and administration where company policies have not been adequately complied with? What suggestions do you have for improvement?*

☐ *Have you discussed with management the results of your review of compliance with controls and policies? What were the results of that discussion?*

Management

☐ *Are the company's policies and practices with respect to internal accounting controls adequate in relation to the requirements of the Securities and Exchange Act of 1934 as amended by the Foreign Corrupt Practices Act of 1977? When were those policies and practices last reviewed by top management?*

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[1] In this regard, our firm has recently published a book, *A Guide for Studying and Evaluating Internal Accounting Controls,* which describes one approach to a management review of the system of internal accounting controls.

☐ *What are your views with respect to the recommendations of the internal auditors and independent auditors for improving the company's internal accounting controls?*

☐ *In reaching decisions with respect to the implementation of recommendations by the auditors, has the cost/benefit relationship been considered?*

Independent Auditors

☐ *What was the extent of your review of the system of internal accounting controls?*

☐ *Have all material weaknesses in the system of internal accounting controls noted during the audit been brought to the attention of management and the audit committee?*

☐ *Do you concur with management's views as to the practicality of implementing your suggestions for improving internal accounting controls?*

☐ *How would you compare our system of internal accounting controls, in terms of both policies and compliance, with other companies in our industry of comparable size and possessing similar computer systems?*

☐ *What are your views as to the need for management and/or our internal auditors to conduct a special study of the adequacy of the system of internal control?*

How to Communicate Results

The audit committee should report periodically on its activities to the full board of directors. This should increase the board's awareness and understanding of the company's financial affairs and assist directors in discharging their responsibilities with respect to the quality of the company's financial reporting.

How the audit committee reports the results of its activities will, of course, depend on the personal preferences of the board and the audit committee and may vary from one board meeting to the next, depending on the significance of the matters to be reported.

Generally, however, the agenda for audit committee meetings, together with any background material, will serve as the basis for a report to the board on topics covered and conclusions reached. In addition, a brief explanation of the report of the audit committee, including topics covered and conclusions reached, may be included in the minutes of the board meetings.

Summary of Recommendations

Following is a summary of the recommendations set forth in this booklet for effective use of audit committees:

- Publicly owned companies, some privately held companies and certain other organizations with a public constituency (e.g., universities and nonprofit hospitals) should establish audit committees to assist the board of directors or trustees in discharging their responsibilities to shareholders and others.
- The committee's objectives and responsibilities should be set forth in a written document approved by the full board. The content of this document should be flexible enough to cover new situations as they arise.
- The committee should normally consist of not fewer than three, nor more than five, members.
- At least a majority of, and preferably all, the committee members should be outside directors.
- The term of appointment as a committee member may be left to the discretion of the board; however, provisions that would maintain some continuity while simultaneously bringing fresh perspectives to the committee are desirable.
- There should generally be at least two meetings of the audit committee during the year, and additional meetings should be held as circumstances warrant.
- Written agendas and background material should be distributed to committee members and participants in advance of each meeting.
- The committee's principal functions should be to:
  - Approve the selection, retention or termination of the company's independent auditors.
  - Review the proposed scope of the audit and related fees.
  - Inquire about and be aware of all work (audit, tax, systems) that the independent auditor performs for the company.
  - Review the annual financial statements and the results of the audit with management, the internal auditors and the independent auditors.
  - Review with management and the independent auditors the recommendations made by the auditors with respect to changes in accounting procedures and internal accounting controls.
  - Review the memorandum, if any, prepared by the independent auditors setting forth any questionable, or possibly illegal, activities and take appropriate action.
  - Be available to meet with the independent auditors to resolve problems that arise in connection with the audit if and when this becomes necessary.
- The audit committee should periodically report to the full board on its activities.

Once a company or organization perceives the need for an audit committee, the implementation of these nine recommendations should contribute significantly to the fulfillment of that need.

Looking Ahead

If we accept the past as an accurate guide to the future, then the acceptance of corporate audit committees seems assured. In 1972, for example, when we published our first commentary on this subject, most audit committees served only the nation's largest and most diverse corporations. Today, audit committees are functioning in many small and medium-sized companies as well as the very large ones. By June 30, 1978, of course, all NYSE-listed companies must have functioning audit committees.

Whether congressional legislation or agency regulation lends additional impetus to the movement toward audit committees remains to be seen. Regardless of that, the inherent benefits of the audit committee seem certain to win over most of the publicly held companies that, for whatever reasons, have delayed acting on this important issue.

We believe, too, that a growing number of private corporations and nonpublic institutions and organizations will establish audit committees to oversee their financial operations and monitor their relationships with independent auditors.

Though the prime stimulant in the tardy, somewhat hesitant, move toward audit committees may well have been scandal, litigation and the threat of legislation, we believe corporate boards will come increasingly to the recognition that discovery of the corporate audit committee was an act of serendipity.

EXHIBIT G

Corporate Directorship Practices: The Audit Committee

By Jeremy Bacon

A Research Report from The Conference Board

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Some Particular Post-Audit Concerns

Some audit committees single out a few aspects of a company's accounting or other practices for special attention during the post-audit review.

Internal Controls

The emphasis being put on internal accounting controls, especially as a requirement of the Foreign Corrupt Practices Act of 1977, places this item on the agenda of numerous audit committees when the time comes to consider the results of the annual audit.[1] These committees ask the independent accountants to evaluate and report on the effectiveness of the company's internal control system, to locate any weaknesses, and to recommend corrective measures where needed. Since the SEC is moving toward requiring a statement from companies as to whether their internal controls are in compliance with the Act, this post-audit agenda topic may become increasingly prevalent.

Some examples of what committees have been authorized (or charged) to do in connection with the outside auditors' appraisal of internal controls:

> "To review with management and the auditors the auditors' evaluation of the scope and adequacy of the internal accounting controls of the company and their impact on the company's financial statements, and to report to the board of directors in connection therewith."
>
> —A utility company

• • •

> "Invite the auditor's recommendations regarding internal controls and other matters."
>
> —A manufacturing company

• • •

> "To review with the public auditors and with the company's director of internal audit and controller internal audit procedures, detected weaknesses, and corrective actions."
>
> —A consumer products company

• • •

> "Meetings should be held with the independent auditors to discuss their findings and management's response to such findings. These discussions would cover the company's internal controls and accounting procedures."
>
> —An industrial equipment company

For further discussion of the audit committee's involvement with internal controls, see page 35.

Accounting Principles and Policies

Some audit committees focus on accounting principles and policies in their post-audit review. Key concerns of committee members at this stage might include:

- Whether the company's practices conform with generally accepted accounting principles;
- How the company's accounting practices and policies compare with those of other companies in the same industry;
- Where a choice of treatments is permissable, whether the approach taken by the company is the best, using such yardsticks as conservatism and long-term versus short-term consequences;
- What the effect of a choice of accounting principles has had on financial statements;
- Whether management and the independent accountants had any significant differences of opinion over the choice of accounting principles to be followed (where there was a choice), and what the outcome of any disagreements were.

Here is how one bank's board resolution phrases this duty for the audit committee:

"To review the financial reporting system of the corporation and its subsidiaries, including balance sheets and operating statements, proviso that it follow up on recommendations the committee itself may have made, as well as on any made by the outside (or inside) auditors.

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[1] Jeremy Bacon, *Requirements of the Foreign Corrupt Practices Act and 1978 S.E.C. Disclosure Rules.* The Conference Board, Information Bulletin No. 55, 1979.

Evaluating the Internal Audit Staff

Just about a third of the audit committee charters that include internal auditing as an area of responsibility for the committee specify that this responsibility includes, in the words of one statement, an assessment of "the quality and depth of staffing in the company's internal auditing functions." In other words, these committees are supposed to evaluate the quality of the company's internal auditing staff, including but not limited to the chief auditor. Yet, as one executive pointed out, the chances are that if an audit committee makes an assessment of the effectiveness of the internal auditing system it will evaluate the staff in the process, even if it is not specifically instructed to do so; the committee members know that the caliber of the people who implement the system is as important as the system itself—perhaps even more so.

In one bank's list of duties for the audit committee, the committee not only reviews the results of audit activities at least quarterly, but it also reviews the chief auditor's salary and the annual budget of the internal audit department, a process that necessarily involves the committee in personnel evaluation.

An obvious source of information on the quality of the internal auditing staff is the *outside* auditing staff, and audit committees turn to that source, typically as part of the agenda for the post-audit meeting with the outside auditors. But one committee member expressed some reservation about the answers that outside auditors give to questions about the company's inside auditing personnel. In the experience of this executive, independent auditors can have a sense of professional superiority that leads them to give staff people appraisals that are more polite than dependable. In any event, some audit committees do ask the outside auditors for their comments on the internal staff. In fact, this is a specified duty in some committee charters.

Reviewing or Monitoring Internal Controls

Some committees have formal responsibility for reviewing internal controls, even though they have no other specified duty where internal auditing is concerned. For example, a board resolution governing one audit committee gives that committee the following duty, among others, but makes no other reference to internal auditing: "Consult with the independent auditors, the internal auditors, and corporate management, together or separately as appropriate, with regard to the adequacy of internal controls." Similarly, another committee has this assigned function, the only one of its duties that mentions internal auditing: "Discuss with the independent auditors and the internal auditors the adequacy of the company's accounting, financial and operating controls."

More typically, however, the audit committee's written responsibility for reviewing internal controls is included with other aspects of a broader mandate to monitor the internal auditing function. An example: "To review and discuss with the internal audit staff of the corporation and appropriate corporate officers matters relating to corporate financial reporting and accounting procedures and policies, adequacy of financial, accounting and operating controls, and internal audit program."

Maximizing Internal Auditing Independence

The audit committee can play a role in maintaining the internal auditing function's independence and, in fact, this role is written into 28 percent of those charters that mention internal auditing as an audit committee responsibility. A sample statement (for others, see the box on page 36):

> "Meet periodically with the company's financial staff to assure that the framework exists for the internal auditing staff to express its concerns, either directly to the audit committee or through the independent public accountants."

The Audit Committee and the Independence of Internal Auditors: Excerpts From Bylaws, Board Resolutions, and Committee Charters

"Satisfy itself that the internal auditing staff is protected from undue pressures and is provided with as much independence as is necessary to work in compliance with recognized standards of internal auditing."
—A transportation company

"Confer, as the committee feels necessary, with the company's internal auditor. Retain and uphold the principle that the internal auditor reports only to the chief executive officer and the committee and is independent of all other internal direction."
—A petroleum company

"Consult with the independent auditors (as appropriate, out of the presence of management) and when appropriate the internal auditors to establish direct communication between these auditors and the board and assure them the freedom, cooperation and opportunity necessary to accomplish their responsibilities."
—A manufacturing company

"Provide the independent and internal auditors with a direct and impartial, and, when deemed necessary, confidential, line of communication with the board of directors."
—A manufacturing company

The most common means by which audit committees bolster the independence of internal auditors is to provide them with direct access to the committee, and thus to the board of directors. Without this direct avenue of communication to the board level, the internal audit function can find it difficult to adhere to positions or recommend procedures that do not meet with management's approval, and may even have trouble getting management's cooperation in the audit process.

Contact with the audit committee also gives the internal auditors increased status and authority. The Conference Board report on internal auditing cited on page 31 notes:

> "According to some managers, the very fact that they meet with the committee and report to it on their activities has helped auditing to gain greater recognition and cooperation from management. One audit manager said that he detected a change in operating management's attitude once audit committee members were included on the distribution list for all audit reports. Another manager said that the committee is his 'big club,' with the potential to be used if an auditee causes unwarranted difficulties." (page 58)

One channel of access that audit committees make available to the internal auditing staff is face-to-face meetings with the committee. In fact, some committee statements of responsibility make meetings mandatory: A utility's audit committee has these two duties, among others: "Be available to meet with the internal auditors to discuss internal audit programs, audit findings, and recommendations": and "Meet periodically with the independent accountants and the internal auditors without management representatives being present."

Some audit committees also give the internal auditors assurances that the auditors can contact the committee or committee chairman between meetings. Occasionally, the burden for this kind of communication is shifted from the committee to the auditors, so that instead of a requirement that the committee be available to the auditors, there is a requirement that the auditors bring to the committee's attention any real or potential problems. An example of instructions in a board resolution setting up this latter situation: "Instruct the independent accountants and internal auditors to communicate directly with the committee on any matter which, in their judgment, the accountants and auditors have not satisfactorily resolved with the management." For another committee the pertinent wording is: "Similarly, the company's independent accountants, general auditor, general counsel, and financial management will have full access to the committee and to the board of directors and each is responsible for bringing before this committee or its chairman in a timely manner any matter he feels appropriate to the discharge of the committee's responsibility."

Reporting Relationships to the Audit Committee

It is rare for the internal auditing function to report directly to the audit committee—in the sense of that committee's being internal auditing's "boss"—which is what one might expect for any corporate staff or unit. Only 14 companies in *Internal Auditing*, for example—5 percent of the total—had such an arrangement, and in all but two cases it was a *dual* one: Internal auditing reported to a corporate executive in day-to-day administrative terms, and to the audit committee functionally (and usually much less frequently), to satisfy certain review and approval responsibilities of that committee in those companies.

The survey for this report indicates that if the question of reporting relationships to the audit committee is asked in less specific or restrictive terms so that *any* formal reporting relationship may be included, a significantly larger percentage of companies (although still only a minority) will give an affirmative response. Thus, 152 of the respondents to this survey—just about one-fourth—said that internal auditing has a formal reporting relationship of some kind to the audit committee in their companies. (In about 15 percent of these cases, the relationship is to the committee chairman rather than to the committee as a whole.) But it seems clear even in these companies that the internal auditing function as a rule looks primarily to a corporate executive for day-to-day leadership and guidance, and that the reporting line to the board is an additional rather than an exclusive one.

The following excerpt from the function description of an audit committee illustrates an arrangement of multiple reporting responsibilities for one internal auditor (that of a petroleum company, in this case): ". . . the internal auditor reports only to the chief executive officer and the committee and is independent of all other internal direction. However, in the day-to-day functions of the company, the internal auditor reports to the financial vice president."

The idea of having internal auditing report directly and exclusively to the audit committee rather than to management has been suggested as one way to maximize the auditing function's independent status. A number of audit committee members and chairmen were asked during interviews how they felt about this suggestion.

Their negative reactions to the idea help to explain why the practice is an unusual one. Even some who conceded that such an arrangement would enhance the independence of the internal auditing function were strongly opposed on practical grounds. The chief reasons they gave for their opposition are:

- Audit committee members are already very busy; they are pressed for time and meet too infrequently to be in a position to supervise a corporate function.
- On the opposite side of the same coin, internal auditing needs close supervision. The recruitment and training of personnel, salary administration, audit assignments, and so on are activities that make part-time leadership impractical, according to one view. Another factor mentioned is that internal auditing is a training ground for future management in many companies and, therefore, the auditing staff requires continuing leadership and internal guidance.
- Internal auditing is really a tool for the benefit of management, a public accountant argued; a reporting relationship to the board level can deprive management of control over a badly needed source of help. It can also be seen as "policing" management, said one committee member, something that should only be necessary if management's integrity or ability is in question.
- Direct reporting responsibility to the committee is not essential to the independence of the internal auditing unit; unrestricted *access* to the committee serves the same purpose.

Table 8: People Involved in Determining Agenda for Audit Committee Meetings (alone or with others), 100 Companies

Person or Group	*Number of Times Mentioned*		
	Alone	*With Others*	*Total*
Committee chairman	28	39	67
Chief financial officer	4	18	22
Outside auditors	1	16	17
Secretary of committee or corporate secretary	2	14	16
Internal auditor	1	12	13
Controller	—	11	11
Committee as a whole	3	4	7
Chief executive officer	—	7	7
Other management (not specified)	—	5	5
Corporate counsel	—	2	2
Board of directors	—	1	1
Totals	39	129	168

More than anyone else, the chairman of the audit committee is likely to play a part in determining what the agenda for meetings will be. However, Table 8 shows that agenda are not usually the product of one person. (The table is based on an analysis of 100 arbitrarily selected survey responses.)

One procedure reported by audit committee chairmen for selecting items for agenda is to consult with all interested parties—the outside auditors, the inside auditors, and financial (and general) management and the committee members—and compile the final list on the basis of what is suggested. But some chairmen rely primarily on one source (the CFO seems to have the edge) for a suggested list of topics, which they as chairmen use their judgment to reshape or enlarge upon. A minority of chairmen, as Table 8 shows, set the agenda by themselves.

It can be seen in the table that the outside auditors are the third most frequently mentioned source of topics for the agenda of audit committee meetings, at least in these 100 companies. A senior partner of a Big Eight accounting firm explains one reason for this when he points out that accountants see the increased demands being made on audit committees as an opportunity to serve their client better. His own firm, for example, believes in taking the initiative in suggesting agenda items to clients' audit committees, and he feels that committee members appreciate this because it helps them do their job. The accounting firm includes in its suggested topics opportunities to bring committee members up to date on important developments in accounting principles and the like, which the members welcome.

Meeting Minutes

Almost all (89 percent) of the surveyed companies report that their audit committees keep formal minutes of what happens at committee meetings. These companies were asked to indicate the extent of detail and comprehensiveness of their audit committee minutes, with the following results:

Degree of Detail	Percent of Companies Keeping Minutes
Detailed as to topics, sense of discussion, actions taken	38%
Comprehensive, but an outline or summary, not detailed	43
Only highlights or major actions noted	19
	100%

Proposed Plan for Meetings of the Board Audit Committee

Number and frequency of meetings

Three meetings per year will be held on the afternoon or evening prior to the February, August, and December meetings of the board of directors.

Advance preparation for meetings

During the period December through April, independent accountants meet with the company's Auditing Manager and Controller at various times to coordinate the broad scope of the forthcoming year's audit.

Ten days in advance of each Board Audit Committee meeting, independent accountants meet with the company's Auditing Manager to formulate a proposed meeting agenda for submission to the chairman of the board Audit Committee.

Attendees at each meeting

Members of the Board Audit Committee.

Representatives of the independent accountants (partner in charge and audit manager).

Company representation: Executive Vice President for financial affairs, Vice President-Finance, Auditing Manager, Secretary and General Counsel (who will act as secretary of meetings), and Controller.

Agenda

February meeting:

Approve minutes of prior meeting.

Final report on audit—independent accountants.

Report on internal audits—Auditing Manager.

Formulation of committee's report to the Board of Directors—chairman of audit committee.

Recommendation for nomination of independent accountants for the ensuing year.

Review of any particular items or areas that the Board Audit Committee desires to be investigated by the independent accountants or the internal audit staff. (Also applicable to all other meetings of the Board Audit Committee.)

August meeting:

Approve minutes of prior meeting.

Review internal audit plan and scope for current year—Auditing Manager.

Locations to be visited and functions to receive emphasis.

Review independent accountants' audit plan and scope for current year—independent accountants.

Audit coverage of:

- Domestic subsidiaries, plants and parts facilities.
- Subsidiary companies outside the United States.
- Affiliated companies.

Areas of significant audit emphasis (inventories, salaries, etc.).

Coordination with Auditing Department.

Discussion of any new significant accounting, auditing or reporting matters—independent accountants.

Review significant internal control recommendations—independent accountants.

December meeting:

Approve minutes of prior meeting.

Review status of current year's audit and discussion of any significant matters under consideration—independent accountants.

—An industrial equipment company

These figures would seem to confirm statements in conversations with audit committee members and chairmen and others that minutes have been growing longer and more detailed. The main impetus cited for this change, where it has occurred, is a desire on the committee members' part to document their thorough and conscientious approach. One audit committee secretary, who is his company's chief financial officer, observed that this is the only committee on his board that has detailed minutes; a possible reason is that the committee chairman is an attorney. This executive also said that it has become something of a struggle to get

Schedule and Purpose of Audit Committee Meetings
--A scientific equipment manufacturer

The audit committee shall meet at least three times with independent auditors and financial management. The primary purpose of these meetings will be as follows:

(1) A meeting to be held in the spring (probably May) to discuss the scope of the examination, locations to be visited, and staffing. The independent auditors will issue a report prior to the meeting which will explain their audit plans for the year.

(2) The second meeting, to be held in the late fall (probably November), will include discussions of the results of interim examination at central offices and outlying locations to date. The independent auditors will also discuss recent accounting developments, areas where generally accepted accounting principles and practices may require treatment varying from that proposed by the company, if any, and other matters of current interest.

(3) The third meeting will be held after preparation of a draft of the financial statements (in February) with the purpose of reviewing such statements before releasing earnings to the public and printing of the annual report.

the minutes approved by all committee members, each of whom examines them carefully.

Slightly more than half (55 percent) of the committees that keep formal minutes submit them to the full board.

Who Attends Meetings

As earlier chapters have indicated, today's typical audit committee confers during the year with the outside auditors and with management, and, increasingly, with the internal auditing staff (or at least the general auditor). It was also pointed out that it is considered important to have the committee meet with these people or groups—especially the outside auditors—alone, so that matters can be discussed candidly and sensitive issues can be broached in an atmosphere of confidentiality. That does not mean, however, that audit committees hold a series of separate meetings with these parties; typically they meet jointly with whoever needs to be consulted about—or is immediately involved in—the agenda topics for the particular meeting, and request one party or another to leave the room as the situation warrants. As one committee chairman put it, chief executives are growing accustomed to being asked to excuse themselves—an experience some of them find unsettling at first.

Although the need to meet privately with the outside auditors without management present has always been acknowledged and honored by the typical audit committee, there appears to be a trend toward including this as a specific duty in committee function descriptions (see the Appendix, for some examples). Some committee-function documents also mandate meetings with the internal auditors; see page 36 of the preceding chapter.

The Committee Secretary

Cooperating companies were asked to state who keeps the minutes of audit committee meetings, or otherwise acts as secretary of the committee. Table 9 shows who serves in this capacity in 612 companies, and it is clear that the job falls most often to the corporate secretary, although the corporate secretary is not usually a member of the committee. The second most common choice for secretary of the committee is one of its members, typically asked by the chairman to take the responsibility. The table shows that nine chairmen in the surveyed group act as secretary themselves; and that a dozen committees have chosen to have a corporate attorney (who would not usually be a committee member) serve in this capacity.

Besides keeping minutes of meetings and also handling committee correspondence, such as sending out advance agenda, the secretary, whether or not a committee member, can also be influential in committee matters. He or she works closely with the committee chairman and, as Table 8 indicates, may be one of the people who has a say in drawing up agenda.

Schedule and Purpose of Audit Committee Meetings

—A utility company

The Audit Committee shall have an established schedule of meetings, on a recurring basis, as follows:

(1) January—a separate meeting with company accounting officers, as an information session on current internal audit work and plans for the succeeding year, accounting and reporting problems, and examination matters generally.

(2) February—a joint meeting with company officers and independent accountants, in connection with consideration of the financial statements and reporting for the year ended December 31 immediately preceding. In conformity with the company's continuing policy, the independent accountants and the company's principal accounting officers shall attend the meeting of the full board of directors at the time the Chairman of the Audit Committee reports on the independent accountants' examination, report and opinion on the financial statements of the company and its subsidiaries for the fiscal year.

(3) June—a joint meeting with company accounting officers and independent accountants, following stockholder action on the appointment of independent accountants, in connection with the planning and status of the audit for the current year. If desired, the committee could meet privately with the independent accountants following the joint session.

(4) December—a separate meeting with independent accountants, in anticipation of consideration by the board of directors of appointment of independent accountants for the ensuing year, and review of the current year examination status.

The foregoing schedule of joint and separate meetings is acknowledged as providing an arrangement which should meet the purposes and objectives of the committee, but the schedule and general content of meetings are to remain flexible to accommodate any required changes. It is understood that in addition to regularly scheduled meetings, additional meetings can be held at any time during the year that such meetings are deemed necessary, including such meetings as may be requested by the independent accountants.

Reporting to the Board

Like any board committee, the audit committee is expected and required to keep the full board informed of its activities; 97 percent of the committees included in the survey report formally to the board at least once a year. With the increasing importance of the audit committee as the board's eye on important areas of company activity, the committee's reports have also become more significant in many companies.

The frequency with which the audit committees of cooperating companies report to the board during a normal year is shown in Table 10. Twice a year is most common (186 companies); once and four times a year are about tied for second place (131 and 129 firms, respectively); and 107 committees report three times a year. But some committees report considerably more often.

The number of committee reports, overall, lags somewhat behind the number of times the committees meet, but the correlation is close enough to conclude that most committees report to the board following each regularly scheduled committee meeting. A number of cooperators mentioned that committee meetings are scheduled for the day (or morning) prior to a full board meeting, to facilitate reporting (and also to reduce the travel requirements for committee members).

The customary method for the audit committee chairman to report to the full board was described by 606 companies. Half the committee chairmen give an oral report only; most of the remainder (264) add a written report to

Table 9: Person Serving as Secretary of the Audit Committee, 612 Companies

Function or Title	*Number of Times Mentioned*
Corporate secretary	276
A committee member	162
Internal auditor	45
Controller	45
Chief financial officer or treasurer	38
Corporate counsel	12
Committee chairman	9
Corporate executive (title not specified)	7
Outside auditor	5
Other	13
Total	612

Table 10: Frequency with which Audit Committees Report to the Full Board within a Year, 595 Companies

Number of Reports to Board	*Number of Companies*	*Percent*
1	131	22%
2	186	31
3	107	18
4	129	22
5-6	33	6
Over 6	9	1
Totals	595	100%

what they convey to the board orally. A small minority of 35 chairmen submit only a written report, as a rule. Written reports invariably either consist entirely of the committee's meeting minutes or incorporate them.

Two-thirds of the 309 committees that submit minutes to the board do so only to keep the board informed; the board does not approve the minutes. In the remaining one-third of the committees that submit minutes, the board does have to approve them.

One director, who chairs two audit committees, points out that, because one of his committees meets immediately prior to a full board meeting, there is no time to draft minutes, and so his entire report is given orally. For the other committee he submits minutes along with his oral presentation, since there is time to prepare them beforehand. Thus the use of written reports may in some cases be a matter of circumstance rather than of policy or choice.

The chairman of today's audit committee, it seems from numerous comments, expects questions from the board on any aspect of the report that is not clear or complete. Board members are far more prone to ask questions than they used to be, a change usually attributed to the heightened sense of responsibility (and liability) felt by today's director.

Staff or Other Special Assistance

Overall, the concept of having full-time staff assigned to help the board with its duties continues to be stoutly resisted by boards. However, there is evidence that some audit committees do have the benefit of staff assistance in carrying out their responsibilities. There is also precedent for granting specific authority to this committee to engage outside experts—attorneys, accountants or consultants in tax or other matters—if the committee feels independent advice or testimony is necessary. Perhaps more important, many audit committee members seem to feel that they have this authority and are willing to avail themselves of it, whether or not the committee has a specific sanction to do so.

Staff Assistance

The practice of assigning staff help to the committee was explored in the questionnaire by means of the following question: "Are any corporate personnel *formally* assigned to the committee to provide it with staff asistance such as secretarial or legal service or advice, either on a part-time or full-time basis?" Those companies that answered affirmatively were asked to indicate how many such people there were, and whether they served the committee part-time or full-time.

Mr. Hughes. Thank you, Professor, for an excellent statement.

Those bells you hear mean that a vote is in progress, and the subcommittee will resume in 10 minutes.

The subcommittee stands recessed.

[Recess.]

Mr. Hughes. The subcommittee will come to order.

Professor, I apologize for that interruption, but, unfortunately, the House is in session and we will have votes from time to time.

Mr. Briloff. Fully understood.

Mr. Hughes. So, we may have to break for 10 or 15 minutes. Hopefully, we'll have a breather now, because I understand we will not have any votes for at least an hour.

One of the things that concerns me about the Arthur Andersen role you touched upon—and I am going to, of course, pursue it with Arthur Andersen—but I've spent a lot of time studying and analyzing that March 7, 1980 memorandum, the memorandum that you alluded to, which there was a meeting with representatives of Arthur Andersen & Co. and E.F. Hutton, where Bill Sullivan explained Hutton's procedure and where Arthur Andersen, at the conclusion, indicates that—and Joe Miller makes a statement that—he would discuss the matter, that is dealing with their concerns. And they obviously, already, had some concerns about this aggressive overdrafting—even as early as 1980, at least some signals were up that that was something that they should look at—and Joe Miller is to talk with the partners at Arthur Andersen & Co., whose clients include major money center banks, to ascertain what the banks' point of view is regarding these transactions.

Now, I have seen nothing yet to suggest that there was any such followup; but I think you put your finger on something that gives me even greater concern, and that is that in the following years, when these audits were made, there didn't seem to be any followup. Certainly, the signs were evident, then, to put them on notice that something was wrong. I can't imagine them accepting that brushoff by the general counsel, Mr. Rae, that he was too busy to furnish them with a legal opinion after advising them that he felt that what was the practice of E.F. Hutton that ultimately led to 2,000 counts of wire and mail fraud and a conviction thereon, was—he suggests it was legal but didn't want to reduce it to writing. That, in itself, should have put them on notice.

Do you agree, at that point, that there was something wrong in Denmark?

Mr. Briloff. Most certainly, Mr. Chairman; not only wrong in Denmark but wrong in New York. And also, excepting all that Judge Bell said, that somehow during the Sullivan regime things were not that bad—and I'm prepared to accept that just for the moment, because I don't know better—but as Judge Bell said, from there on out things got much tackier, or stickier, or whatever phraseology I used earlier.

Now, certainly, they must have done something. If not, they were so utterly irresponsible, Mr. Chairman—and I'm saying this after a great deal of reflection about that same letter and that same question that you've asked—Arthur Andersen ought to hang up their—or sign off as being auditors and move into some other kind of a profession.

And the point is that they missed something so vital. Here was a client doing something seriously, potentially illegal; and they should know that, given the nature of the entity's business as a security broker-dealer, they could be shut down by the SEC for engaging in these illegal practices. So it is that the going entity was seriously vulnerable. That they didn't followthrough I find completely incomprehensible, and to the extent it is comprehensible it's incredible.

More than that I cannot say. I must leave it to Arthur Andersen to try to rationalize and justify what they did or did not do.

Mr. HUGHES. Well, I can, in all fairness, understand how in March 1980, given the fact that the practices were not as aggressive, that they became progressively aggressive, given the fact that the general counsel of E.F. Hutton has given them a legal opinion, at least orally, I can understand how they might say, "OK, well, we'll take another look at that." I can understand that at that point. But when you take that particular fact and put it together with the aggressive overdrafting that began in earnest in 1981 and 1982, and then put that together with the manner in which they described the activity in the financial statements, I have some serious problems.

For instance, I have some concerns over the manner in which they describe drafts and checks payable. Do you find that that adequately reveals what Hutton was really doing?

Mr. BRILOFF. Mr. Chairman, in terms of debits and credits, certainly the debits fall into place and the credits fall into place. But the critical criticism of Arthur Andersen in that regard is that they did not make the statement really understandable to the readers of the financial statements. In other words, while now, in retrospect, oh, yes, you could see that they have more checks outstanding than cash, therefore there's an overdraft, they should have labeled it and described it for what it was.

By way of an invidious distinction, Mr. Chairman, the AT&T Technologies Corp. follows a practice of money management. And I looked at the financial statement for the year ending 1984, where it is true, they have included in their payables checks outstanding. But then there is this very complete footnote "N" which described to the worlds what it is that was going on. So it is that the world would have been far more sensitized if the overdraft situation were described for what it was for all to see.

Furthermore, they should have, in the notes to the financial statements, have noted the fact that this overdrafting, as the record discloses, was Hutton's form of borrowing interest free, of borrowing from the banks, through the chaining, crisscrossing and other procedures that were there involved. And if we look at that March 7, 1980 letter, they referred to the fact that there are customers' deposits, cash that's on deposit in those accounts, and customers' securities, to the extent available, are also in those accounts. Consequently, as I believe my prepared statement makes clear, the disclosure should have said, "We have these overdrafts which are being used as loans payable to the banks, and as an incident to that, customer securities and cash balances are potentially being held as collateralized against them;" again, a fuller discourse in disclosure.

Mr. HUGHES. Is it a standard practice, accepted practice, in the profession of accounting to describe an overdraft as a check payable?

Mr. BRILOFF. As an incident to some inquiries along the way, the so-called NAAR system—that's the National Automated Accounting Research System—was probed to see how many companies had the legend drafts and checks payable, so that there were but three companies that were thus described. Now, sadly, in the accounting profession, when, for example, the E.F. Hutton thing got into the data bank of the American Institute which sponsors the NAAR system, when the Hutton legend "checks and drafts payable" got in there, I venture to say that other companies caught on to what it is that was going on and suddenly said, "You know, we've discovered a new kind of a legend for this; instead of the rather pejorative term, 'cash overdraft,' we'll just separate them and call them 'drafts and checks payable.' "

The point is, if this is permitted to continue, it's going to proliferate in so many instances because of the fact that, sadly, in accounting Gresham's Law prevails, "A cheap precept will drive a hard precept out of existence." So it is not common, but it is base and it is endangered of becoming more common unless this is stopped.

Mr. HUGHES. Is it fair to say that the term "overdraft" is used by firms to describe those transactions where there are insufficient funds on deposit to cover a check passed in excess of that amount?

Mr. BRILOFF. All I can say is that if I had that situation in my client circumstances, I would most certainly present it as overdrafting cash accounts.

Mr. HUGHES. Well, overdrafting—certainly, if, in fact, the term "overdraft" had been used, it would have described more accurately the transactions, would it not?

Mr. BRILOFF. Most certainly. And anyone looking at it—and I'm certain that Arthur Andersen—would have to say, certainly in an accounting sense, "The checks drawn on the account exceed the cash balance, therefore it represents an overdraft."

Mr. HUGHES. Professor, the following statement was included in note 11, "Contingent liabilities in the notes of the financial statements in the company's 10-K form for 1984," and I quote:

> The company and its subsidiaries are defendants in legal actions relating to its securities, commodities, investment banking, insurance and leasing businesses. Certainly these actions purport to be brought on behalf of various classes of claimants and seeks damages of material for indeterminant amounts. In the opinion of management, these actions will not result in any material, adverse effect on the consolidated financial position of the company.

In your opinion was this disclosure adequate, given that it was a little more than a month before Hutton pleaded guilty to 2,000 counts of mail and wire fraud, that, obviously, at this time, Andersen was on notice of the ongoing grand jury investigation, and, in fact, had been subpoenaed? Is that adequate to describe——

Mr. BRILOFF. Mr. Chairman, I hope you will forgive me if I repeat an observation that I've made in other contexts; but this is so appropriate in this situation that I can't avoid it, and so do forgive my repetition. But this disclosure was very much like a bikini bathing suit, what it revealed was interesting, what it concealed was vital.

The point I'm making, if in the 10-K for 1984 you were to look, you would see that there's a far more strident statement under, I believe, "Legal Proceedings," where they describe, as the concluding sentence, that potentially and contingently the grand jury probing might lead to, I believe, a rather serious impact on the company's business. So it is that if this were a relatively small broker dealer in Arkansas, for example, or whatever State in the boondocks somewhere, I can't help but believe that the Securities and Exchange Commission would have shut them down peremptorily when they saw these 1,000 violations. And, as a consequence, as of the time of that particular financial statement—as I recall it was promulgated in late March 1985—E.F. Hutton & Co. was seriously vulnerable as a going entity. And if I recall correctly, they are still vulnerable today, because the SEC has indicated that it would reach a determination, I believe, after 6 months or so.

Conceivably, therefore, there was a going concern contingency, which is one of the most drastic kinds of contingencies that one can conceive of in connection with financial statements. Consequently, given all of those circumstances—again, we know a lot, now, with hindsight, but as of March 1985, I believe that Arthur Andersen should have qualified their opinion and said, "Except for or subject to what it is that you will find under contingencies these statements present fairly"; so that I severely and intensely believe that that footnote was not descriptive of what was. And, if I may again use one more phrase, Arthur Andersen, at that time and probably now, was running a "river boat gamble."

Mr. HUGHES. Thank you.

The gentleman from Florida.

Mr. MCCOLLUM. Professor Briloff, with regard to the memorandum of March 1980, about the legality of the cash concentration system and these overdrafts, and they apparently asked the opinion of the general counsel of E.F. Hutton and he gave it orally but not in writing, should Arthur Andersen at that point have gone to their own attorneys or some outside attorney and asked that same question?

Mr. BRILOFF. Oh, most certainly, and presented the full set of facts to their own attorneys. And for that reason I would be looking for contemporaneous memorandums as to just precisely what they did do, particularly, sir, in view of the fact that they should have seen, as they knew, that counsel was also a member of the board of directors of the corporation, therefore intensely part of management. It wasn't even as though you had a general counsel that occupied that position with that critical oversight, and who, in turn, developed some important sense of objectivity.

Mr. MCCOLLUM. So, an accounting firm, especially one of the size of Arthur Andersen dealing with corporations the size of E.F. Hutton, in your judgment, in cases where there is a legal question, should always consult an outside attorney; is that correct?

Mr. BRILOFF. Especially where it's very critical to the determinations that they're going to be making regarding the financial statements, yes.

Mr. MCCOLLUM. Do most accounting firms like Arthur Andersen have their own attorneys or have attorneys of counsel to them?

Mr. **Briloff**. I'm really not in a position to state categorically, but I know, for example, Arthur Young does, I know Pete Marwick does, and I'm presuming Arthur Andersen must have and all the major accounting firms must have.

Mr. **McCollum**. I think you've made some excellent points this morning, and I, for one, believe that in the accounting area you have given us the reasons to question very seriously whether the practices either in this case or perhaps in many others dealing with large corporations are adequate and appropriate for public consumption. But I am concerned about one portion of your testimony that gets into an area that is not accounting but rather the question of judging the law and judging the Justice Department.

You did not elaborate on that in your oral testimony, but in your written testimony you criticize at some length the Justice Department for not prosecuting individuals. And I'm concerned because I think you'd share with me the fact that it is morally incorrect and probably ethically impermissible to indict an individual whom an attorney or an assistant U.S. attorney does not feel, in good faith, he can convict. And that would cut the number of probable prospects of prosecution to no more than five and maybe two.

Considering the inadequate law, a case of first impression that we have in this instance, a 2- or 3-year trial before a typical jury, do you still feel the need for individuals to be indicted in this case, Professor?

Mr. **Briloff**. Inasmuch as corporations are inanimate objects, creatures of law, their acts are determined by individuals. And my comment with respect to the Department of Justice involvement under Roman numeral VI, had to do with the Assistant Attorney General alluding to the fact that they had to send a signal; and I despaired at the fact that that kind of a signal was necessary.

And I then went on, and I'll go on now to say, if the Department of Justice really wanted to send a signal, regardless of what it is that might have come out at the end, either a hung jury or a complete acquittal, the very fact that the Department of Justice determined that it is not corporations that err but individuals within the corporations who are critically responsible for these judgment calls who have erred, then proceed to whatever end it might lead to.

Mr. **McCollum**. Professor, one of the grave problems that the Department of Justice apparently had to wrestle with was the fact that if they had gone to trial, restitution of banks would have been limited to those in the middle district of Pennsylvania that this was applicable to. They would have also had to have had problems, in that there was no civil injunction that they could have obtained for acts like the weekend multiple drawdowns without bank notice and so on.

You would, in your judgment, believe that the value of public prosecution of individuals would outweigh that kind of judgment they made to get the other that they couldn't have gotten without the prosecution? I mean, I'm not trying to beg the question, but I'm just trying to point out that there was something to wrestle with here beyond the question of public trial of individuals.

Mr. **Briloff**. I hope you don't mind the fact that there was a sardonic smile that came to my visage as you were speaking. I do apologize.

I will take it both ways. Bear in mind that the outer limit as envisaged for this restitution was $8 million.

Now, is $8 million so important in terms of all that was here involved conceptually? Again, under the rubric "governance and accountability." But probably even more importantly now—let's take Judge Bell's statement—there are nothing but "peanuts" involved here. So, for peanuts the Department of Justice determined to roll over and play dead, except for $2 million, which is a bit more expensive than peanuts, at least for me, and $8 million is four times that. But it demonstrates the speciousness of that argument——

Mr. **McCollum**. But what about the lack of the civil injunctions? If they hadn't gone through they couldn't have got injunctions, they couldn't have gone as far. In other words, what they would have been trying would have been a very narrow case in a very limited situation, and what they got out of this, apparently, was not only an agreement from E.F. Hutton to stop practices they couldn't have gotten them to stop otherwise, but also, a real tough signal in that area, the other areas, to other companies.

Mr. **Briloff**. You and I, we are not enjoined by the Department of Justice with respect to those actions. But if you and I were to read what it is that Hutton was enjoined from doing, I venture to say, as an article of faith, you, and I, and others who are committed to being law abiding—would be correspondingly enjoined. Therefore, they were merely enjoined from violating the law.

Again, unless they could demonstrate the fact that Hutton was enjoined from doing something that was even permissible and legal, and if they were enjoined from doing something that's permissible and legal, then I would ask the question, why is it still permissible and legal and why should Merrill Lynch be permitted to do that which Hutton was enjoined from doing?

The point I am making, and not very effectively, but I can capsulize it by saying I am prepared to state as an article of faith that that which Hutton was enjoined from doing, Merrill Lynch, which was not the subject of this injunction is similarly enjoined from doing.

Mr. **McCollum**. Professor, my time is up, but I want to say that I think your point and mine aren't too far off. I just simply would beg to differ, probably, with the conclusion, because I think the question here is one more of whether they could have gotten a conviction rather than whether or not the issue of whether these things were illegal; and I think they got an awful lot for what they did. But that's a judgment call and I can beg to differ on that. I think your accounting statements, though, have been excellent.

Thank you, Mr. Chairman.

Mr. **Hughes**. Because I recognize the gentleman from Florida, I just want to assure you that that is part of the focus of subsequent hearings, because the bottom line for all these hearings is whether or not justice was served, whether the Department of Justice really cut a good bargain or whether they disserved the public interest. That is something that, hopefully, this committee will arrive at when we complete these hearings.

The gentleman from Florida, Mr. Smith.

Mr. SMITH. Thank you, Mr. Chairman.

Professor, I'm very interested in the questions and answers which were just put to you and which you related back from Mr. McCollum, my colleague from Florida, because on page 10 of your prepared statement, you have indicated, in some rhetorical questions, about whether or not Hutton libeled other companies when they said that they had, in fact, done nothing more than other companies were doing, and yet they didn't identify any corporation, which you said, public owned or otherwise, which evidenced yearend excesses of drafts and checks payable over cash subject to immediate withdrawal amounting to $314 million, $151 million, and $404 million for the years 1981, 1982, and 1983 respectively.

Given the fact that there is some profit made in what I guess you would call bank loans without any approval from the banks for the loan, would, in fact, there have been some significant thought on that part, that a penalty would have been a possible negative consequence down the road?

In other words, if we're talking about whether or not there could have been any kind of final adjudication if there were individual indictments returned—I don't know whether that's a fact or not and nobody can really speculate at this time—whether they could have been convicted or not.

But the kind of money that we're dealing with here, was it money that, in essence, was so attractive that they disregarded the fact that a penalty might have been imposed down the road? Was there a deterrent in place which would have allowed for them not to pursue this course in the first instance?

Mr. BRILOFF. The deterrent, of course, would have been self-restraint and self-discipline. Now, some of that excess, and hence, some of that overdraft, may be the result of the fact that Hutton had issued checks to some of their customers or clients as of December 31, and somehow or other, and for good reason, those checks did not clear. Mind you, the magnitude that was there involved is what it is that, most certainly, should have raised the hackles far more than the eyebrows with respect to an auditor.

Furthermore, the very fact, I am confident, that if they looked at the month-to-month bank reconciliation statements as an incident to the audit of cash, they would see huge amounts of what I call "incestuous checks" outstanding, that is checks drawn by Hutton on bank "B" and deposited in bank "A." Those amounts would have been outstanding as of the close of every month, and it may very well be that those amounts far exceeded the numbers that we have there, because bear in mind what we have would be certain yearend numbers that I culled from the 10-K's, so that on a day-today basis they may have run into staggeringly greater sums. I have not seen any documents which would detail that.

The point I am making is that given those signals, Arthur Andersen as an incident to their independent audit were constrained to carry on a very direct, and overt, and careful circumspect review of the control procedures governing the cash managment and the handling of cash; because—I now tie into another response that I gave—conceivably, given the potential illegality that they saw, the whole business was in jeopardy. So, they saw something in the foundation which was termited and for one reason or another—let them explain why—for one reason or another they determined to make believe the termites were not there and they walked away because someone said to them, "It's no business of yours."

Mr. SMITH. Well, let me ask you this. In your oral testimony you spoke about the independent audit committee and the fact that one of them didn't have the kind of acumen necessary to really make a decision and the other two should have, in your estimation, been capable of making that kind of decision and raising a red flag at the very least.

Does the independent audit committee, as far as you know, see the balance sheet which showed the yearend excess of drafts and checks payable over the cash subject to immediate withdrawal?

Mr. BRILOFF. I am certain that they had it given to them, certainly, and they probably even saw it month to month and so on, but——

Mr. SMITH. Well, let me follow it up.

So, you're certain they saw it or at least had it given to them?

Mr. BRILOFF. Oh, yes.

Mr. SMITH. At that stage, would you believe—and I don't know if you've done research about this prior to the 1980 or 1981 sheet—would you believe that the prior years don't show that same kind of large difference between the drafts and checks payable over the cash subject to immediate withdrawal because they hadn't instituted this program of kiting?

Mr. BRILOFF. I believe I had noted that heretofore.

Mr. SMITH. Well, then, what would be your speculation—and I suppose it could only be speculation, unless you've spoken to those people on the independent audit committee—what would be your speculation as to why that didn't raise a red flag for them? All of a sudden, starting in 1981, there's this enormous difference in the reports which they get and the year-end balances than there were in 1978, 1979, 1980, and the like.

Mr. BRILOFF. Again, to the extent that we've seen the disclosures in the Bell report—and that's the only place where I've seen any references to the way in which the audit committee functioned—they were not alerted by those who were responsible for alerting them, regarding the contingencies that were inherent in what it is that was happening. And those who should have alerted them were, on the one hand—and I'm going to say this initially—the internal control in the internal audit procedures of Hutton, which, I understand, was under the control of counsel, the one who was flim-flamming Arthur Andersen in early 1980.

But, then, it is the responsibility of Arthur Andersen, as the independent auditor who is supposed to know what are the roles, functions, and responsibilities of an audit committee, and know of their relationships to the audit committee—I venture to say they've written monographs about that—should have told the independent audit committee precisely what was happening.

And I despair, and I forget whether it was in the U.S. News & World Report or somewhere, where Mr. Law, one of the members of the audit committee, says, "Well, I guess they were running a loose ship." Well, this notion of a loose ship should have been emphasized for them throughout the years.

Mr. Smith. So you're saying, in essence, that in addition to the failure of Arthur Andersen under normal accounting practices to the corporation, you would also detail a failure of Arthur Andersen to the independent audit committee to which they were directly chargeable to revealing this kind of information?

Mr. Briloff. Absolutely and unequivocally, particularly by reference to the Foreign Corrupt Practices Act. And as my statement makes clear—and I believe it is also at page 10—any audit firm which has 15 or 20 years of experience recalls well what happened in the late 1960's and early 1970's, when internal control procedures for brokerage firms went awry, and then one or the other went "belly up"; and these were major brokerage firms, because——

Mr. Smith. Like Du Pont and the others?

Mr. Briloff. Du Pont, Dempsey Tagler, the old Hayden Stone.

Mr. Smith. Right.

Mr. Briloff. Yes; yes.

Mr. Smith. Now let me ask you one other thing. Now, you talked about the signals that were being sent, and I asked you initially about the signal that might have been perceived to be sent at the beginning when this scheme was originally decided upon by some of the financial people in the E.F. Hutton hierarchy.

But let me ask you this. At the end—and you talked about this, that the signal would have been infinitely greater had there been a prosecution, even if it had come off with an adjudication of not guilty, if it was prosecution against individuals rather than just a negotiated settlement with the corporation. Can you speculate as to how much was the value of all of these drafts and checks payable at the end of each year? Can anybody give some idea of how much really was gotten in interest-free loans by Hutton from these banks through this scheme? Have you done any——

Mr. Briloff. No; because I have not made it a career to try to go through all the data which might have been available; but the data would not have been made available to me in any event. Only Hutton & Co. would know, and even Judge Bell apparently preferred not to know.

Mr. Smith. Can we assume, and from your experience over a very long period of time, is it safe to assume that it was greater than $10 million, which is the total value of this signal which was sent by the $2 million fine and the $8 million reimbursement?

Mr. Briloff. Given the number of years that were here involved, given the apparatus that was developed, given the various contorted procedures that were instituted, if it were for only $10 million, a company like Hutton, I venture to say, would not have entered into it. And the fact that the numbers must have been substantial, now that you ask the question, I recall hearing about the memoranda from Mr. Ball, congratulating someone or other because of what it is that they have earned by way of special interest earnings. As a result, I can't help but feel that the amounts had to be substantial. And when I envisage the fact that here we have Hutton & Co. literally dealing in tens of billions of dollars with a balance sheet aggregating assets of, I don't know, $8, $10, $12 billion, that it would have to be over $10 million.

Mr. **Smith**. Then would you say now, in your estimation, that the signal which the Department of Justice sent by virtue of the negotiated plea in this case really sends no signal at all to another company that if they wanted to get into this scheme, basically, right now, they could anticipate, based on historical or at least legal precedent, a much more of a greater gain than the penalty that might be chargeable to them at the end?

Mr. **Briloff**. Well, I have a far greater sense of faith and confidence in corporate managements, really, and the auditors than would warrant an affirmative answer. I cannot help but believe that only corporations and executives—I believe I indicated this phrase earlier—who would determine to involve themselves in some kind of organized crime syndication and auditors determine to go along with them, would endeavor to follow in the tracks of what E.F. Hutton did, and the Department of Justice, I can't help but feel, would have to move far more aggressively in the future; so that if it does nothing else, these committee proceedings send a signal to the Department of Justice more than any other signal.

Mr. **Hughes**. The gentleman's time has expired.

Mr. **Smith**. Thank you, Professor.

Mr. **Hughes**. I might say, before I recognize the gentleman from Florida, that I'm looking at the consolidated statement of income for E.F. Hutton for the year 1982, and the net interest income, according to my calculations, would have been $50 million in 1982, and in 1983 the interest income is $66 million.

The gentleman from Florida, Mr. Shaw.

Mr. **Shaw**. Mr. Chairman, before I start, that's not just from the overdrafts, though, that's total interest, isn't it?

Mr. **Hughes**. That's the interest income, net interest income.

Mr. **Shaw**. Yes, but that's not just on the overdrafts.

Mr. **Hughes**. No, we're talking about just interest income; and that includes all interest income, the bulk of which came from overdraft.

Mr. **Shaw**. Oh, the bulk did come? That's an interesting——

Mr. **Hughes**. Up to 40 percent, according to our calculation. When I say "the bulk," up to 40 percent, according to our calculation, was a result of overdrafting in those years.

Mr. **Briloff**. If I may interpose, and if you'll forgive me, it may very well be that the important plus to Hutton's income statement was not necessarily from the interest income but the reduction in the interest expense, because they would have had to have borrowed substantial sums for working capital. Because I believe management, in their statements in May, or the Department of Justice, alluded to these overdrafts as avoiding borrowing, hence the avoidance of interest expense; so that the two have to be considered in tandem.

I'm sorry.

Mr. **Shaw**. Professor, I would like to follow up on Mr. Smith's questioning with regard to the liability of E.F. Hutton.

From your testimony I would conclude that you feel that E.F. Hutton's total extent of liability has been negotiated and is capped off at $8 million. Do you really believe that?

Mr. **Briloff**. Well, I don't believe it's capped off at $8 million, because the restitution fund was established at $8 million; and that was not the outer limit, but that was the outer limit that was contemplated by the Department of Justice at the time.

But the point that I believe to be far more relevant in answering your question, Congressman Shaw, is the observation of Judge Bell's report about the fact that it was a lot less than $8 million, only running into hundreds of thousands of dollars.

Mr. SHAW. Well, I think the point should be made, and it should be made very clear, by the plea that E.F. Hutton made, it in no way precludes the banks from going back and suing for restitution, provided they can prove their damages. So, they did not completely plea away liability; in fact, they didn't plea it away at all. Because the Federal Government cannot go in and negotiate for banks and other institutions who have been damaged by the kiting scheme.

Mr. BRILOFF. Well excepting, Mr. Shaw—and this, essentially, was the thrust of the point I made in that context regarding Judge Bell—regardless of what the cap might be, $8 or $80 million, in terms of a restitution fund, it was the procedure that was ordained in the agreement as to how the determinations of liability would be made. It put the onus onto the individual banks, who might or might not, in individual cases, find it cost efficient to go through the agony of making these determinations, particularly where certain of the cards that were being played here might be face down as far as the banks and only Hutton might know. The point I made there was, that just as I believe it was done in connection with the determination of damages to be asserted against Exxon, it was Exxon that had to—I believe it was they—who had to determine the extent to which they had taken advantage of the marketplace through one or another improper course of action, course of conduct, and they had to make the determination. It would then be up to some agency, possibly the Federal Reserve, possibly the Justice Department, to try to identify which banks were involved, and if not the excess might have been devoted, just as it was in the Exxon situation, to some public objective.

Mr. SHAW. Well, Professor, are you saying, then, that it's the responsibility of the Department of Justice to go out and represent the bank and go collect the amounts that might be due them as damages?

Mr. BRILOFF. It is the responsibility as I see it, as a nonattorney, for the Justice Department to represent society and to see, make certain as much as it can, that those who are responsible for the perpetration of crimes may determine that Hutton was——

Mr. SHAW. Professor, you're not answering my question.

Do you think that the Justice Department has a responsibility to go out and collect damages for the banks?

"Yes" or "no."

Mr. BRILOFF. In this context it was the Justice Department's responsibility to determine the measure of damages of the banks and to insist upon the restitution as an incident to the bargained agreement.

Mr. SHAW. Well, I interpret what they did. Now, I agree with you, the figure may be low as the pool that they set up, but I think that they did try to at least establish a fund for the banks to go after. But I would totally disagree with you in any area that you'd say that law enforcement has the obligation to go back and get people who—or collect money, or be a collection agent for the private sector, and particularly for banks.

But while we're talking about banks, let's talk about their audit committee. Do you think the audit committee of the various banks should have picked up what was going on?

Mr. BRILOFF. The audit committee of banks should similarly have discerned what was going on, and bank executives should have discerned the fact that there may have been a plethora of overdrafts that they've discerned that they have to call Hutton on.

And, conceivably, that which the Genesee Bank did in, what, 1982, might well have been done a lot earlier and a lot more frequently. As to why they did not I must leave to the banks for their determination.

Mr. SHAW. Now, there are 400 to 600 bank accounts involved, if I recall the figures correctly; so, I think that what you are saying is that you would think that these banks should call their audit committees to task, to find out what happened, because it seemed to be breaking down in that area, too. Is that correct, Professor?

Mr. BRILOFF. I would say so, yes. Yes.

Mr. SHAW. I might talk about going back to the Justice Department for a minute, and talk a little bit about your statement that we should use indictments to send messages.

I recall, some years ago in Fort Lauderdale, that we had a state's attorney who made a similar statement and got in a world of trouble for it. The grand jury process, itself, is a terribly powerful process, and I don't think that we should use the indictment process, the trial process, to punish people or to send messages. It would certainly be my opinion, and I think the opinion of just about every lawyer on this panel, that certain attention should be given to successful prosecution, and whether or not you have the probable cause to indict somebody, that's a terrible thing to do to somebody unless you know exactly and precisely what you're doing and that you do have a reasonable certainty of success.

Do you disagree with what I just said?

Mr. BRILOFF. Well, actually you combined a number of phrases, some of which I might disagree with. I agree, of course, with reasonable certainty of success, but you, then, also included "exactly and precisely." "Exactly and precisely" is something that tends to escape most of us, certainly in terms of conjecture regarding the future. Therefore, with reasonable certainty, certainly.

Mind you, this, however, was before the grand jury and it was before them for a number of years. As to just what the proceedings were before the grand jury and what the grand jury might have done or might have contemplated obviously is something that is privy to them.

And I, of course, appreciate and fully respect your judgment as an attorney. I interposed my view as a citizen.

Mr. SHAW. Well, you are here testifying as an expert and in your role as a certified public accountant and as a professor. And even though you introduced yourself as a citizen, you weren't invited here because of that.

Mr. BRILOFF. I appreciate that, yes.

Mr. SHAW. I'd like to inquire for just a moment. In an article that appeared September 4, 1985, in the Washington Post, you were quoted as saying you know of "no accounting rule that permits an approved financial statement to reflect an issued check as a liability rather than netted against cash balance." Now, I was particularly struck with that statement, because I thought the same thing and I was in agreement with you. I have been out of the accounting profession now, my CPA certificate has got a little over 20 years on it. I made a similar statement, but after going around and talking to some of the CPA's, I find that things have changed in the last 20 years and that statement is not necessarily true, at least according to accepted accounting principles. And that's what we're talking about, and that's what Arthur Andersen's responsibility is, accepted accounting principles.

Do you still believe that statement that you made to the Washington Post, or is it a correct statement?

Mr. BRILOFF. I do still concur in that statement in the sense that the statement of drafts and checks payable was not responsive to the disclosure requirements that were here warranted. And I made the invidious distinction between the way in which, for example, AT&T Technologies presented it and the way in which it appears here. And I indicated that in my experience, and probably yours from way back then would have said, if this is an overdraft in cash it is then shown as a net cash overdraft rather than showing the debits and credits broad.

I also noted the fact that in recent years, very recent years, given the way in which the Hutton situation apparently crept into the NAAR system in early 1980, that there were others who came in as copycats. So, I go back to the discourse or the dialog I had with the chairman and say I am prepared to accept the liability however they describe it, provided that their footnotes then say these are bank overdrafts which represent borrowings from the banks, which are presumed to be interest free, and against those borrowings, which is what they are, represent—are then collateralized by whatever it is that their early 1980 memorandum indicated was in those banks and available for the banks to utilize.

Mr. SHAW. So you do not believe that it should have been shown as a negative asset.

Mr. BRILOFF. It had to be shown as a negative. If you have an overdraft, it is a liability. It's not an asset, obviously. It's a liability, it's a matter of how do you label it, how do you identify it, and, then, how do you describe it so that the world would understand. Because you and I, in studying accounting, know that understandability is a condition precedent to the development of the financial statements, Mr. Shaw.

Mr. SHAW. Let me ask you, then, to tell me, how do you define this phrase "netted against the cash balance"?

Mr. BRILOFF. What I would have said was, the $100-some-odd million that they had on the debit side, which is cash subject to immediate withdrawal, let's say $100 million, and $400 million of checks and drafts payable, I would have shown as one credit item, "bank overdraft $300 million, see note so-and-so." And I then would have, in that note, have described the Hutton procedures that were in vogue, which either created or intensified this overdraft situation—mind you, as an incident of the disclosure of what it is that was going on——

Mr. **Shaw**. Yes, sir, but you would have left the cash balance on the balance sheet; is that what you're telling me?

Mr. **Briloff**. Not if I'm netting one against the other, Mr. Shaw. In other words——

Mr. **Shaw**. OK, well you would have showed zero cash on the asset side and then 300 or——

Mr. **Briloff**. As the overdraft.

Mr. **Shaw** [continuing]. Whatever it is on the liability side.

Mr. **Briloff**. With a full discursive——

Mr. **Shaw**. Now, is this true even though we're talking about a number of bank accounts? And in some there was a cash balance. But even in that case, this is where you disagree with other accountants that I have talked with as far as what the accepted procedure is. And this is what I was curious to——

Mr. **Briloff**. Mr. Shaw, I am prepared to accept either way providing that the reader of the statements have a fair shot at understanding precisely what it is that was going on under the rubric of cash management at E.F. Hutton & Co.

Mr. **Shaw**. All right. Now, you also mentioned in your testimony, or perhaps it was in response to some of the questions, that Arthur Andersen had a greater responsibility to talk about the grand jury proceedings, in their opinion as well as a footnote to the financial statements.

As I am sure you are aware, grand jury proceedings are secret. How would they have known about that?

Mr. **Briloff**. Oh, Mr. Shaw, you heard only part of what it is that I had said. If we look at the 10-K, under "Legal Proceedings" there is a very important paragraph there. Mind you, this is sometime in March 1985, where, in the 10-K, the corporation makes clear that the grand jury has been investigating their, I believe, cash management, or however they described it, practices, that the grand jury period is coming to a close and one doesn't know what it is that they'll be coming up with, and it is conceivable—again, I forget the phrase—that their determination might have a serious impact, or might impact, on the corporate business or the corporate activities. If you will, it could be read into the record.

The point I'm making now is, I don't want any more disclosure than that which is already there; but that disclosure which is in the 10-K is a contingency that should have been built into the contingency disclosure which is in the financial statement. Mind you, the 10-K was not part of the financial statement packet, as I recall it, that went to the public or which carried Arthur Andersen's direct certification; although they are responsible for the 10-K in general. And given—again, the trail in my stream of consciousness—given the potential inimical impact on Hutton's continuing business, this produced a serious question regarding the continuity of the business. I then went further and said, if I recall, certainly in Connecticut, probably also the SEC, the jury is still out on this particular matter and it may very well be that they may determine on some drastic action with respect to E.F. Hutton. So, I don't want any more disclosure than is already there.

Mr. **Shaw**. I have one more question. I'm already infringing on the time of my colleagues, for which I apologize. But this one, I think, is very important as to the future of the accounting profession.

Accountants are not trained as lawyers.

Mr. **BRILOFF**. Are not trained as what?

Mr. **SHAW**. Lawyers. In fact, you've made reference to that several times during your testimony.

What do you see as the responsibility of a CPA to pick out an illegality and then make it known in his opinion and/or on the financial statements?

Mr. **BRILOFF**. Accountants are not trained as lawyers; nonetheless, we recognize that the entitites that we are auditing exist within a framework of complex laws. And major corporate enterprise like E.F. Hutton, or a multinational corporation, is subject to an elaborate system or nexus of laws. Just as we have responsibility for determining whether the Foreign Corrupt Practices Act is being fulfilled under the Securities Acts——

Mr. **SHAW**. Well, Professor, let me interrupt you.

I believe the complained illegality here would apply against other types of businesses, too.

Mr. **BRILOFF**. Oh, yes.

Mr. **SHAW**. It's just bigger here.

So, what is the responsibility of a certified public accountant to pick out an illegality or an illegal treatment of cash or something that a company is doing illegally, so he can disclose it on the financial statement?

Mr. **BRILOFF**. It's a very pervasive responsibility as I see it. But I will now back up for just one moment and say, certainly to the extent that the auditor senses a question of legality and illegality, that the auditor has a responsibility for following through.

Mr. **SHAW**. But he doesn't have a responsibility to sense it, so if the CPA going through just didn't even think about it, then he's forgiven, but the guy that thought about it is in trouble; is that what you're saying?

Mr. **BRILOFF**. Well, I would put it this way: it may very well be, Mr. Shaw, that as an incident to the audit of a pharmaceutical company the auditor might not know adequately as to whether all of the precautionary and testing procedures have been followed and if, somehow or other, something gets fouled up somewhere in the corporate area, in that area the auditor would not have a direct and overt responsibility, subject, of course, to internal control procedures being in place. However, where the matter of illegality relates to accounting controls, like the kiting of checks, the crisscrossing, the chaining and so on, and especially where the auditor sees, senses, questions, concern about it, most certainly there is a direct and overt liability. So, I will not answer your question completely; broadly and generally, Mr. Shaw, it has to do with the nature and the extent of the law. Certainly, if it relates to the Federal securities laws, the auditor has a greater responsibility than possibly with respect to OSHA. Again, I'm just trying to develop some kind of a dichotomy.

Mr. **SHAW**. That is an interesting observation.

I yield back.

Mr. **HUGHES**. Recognize the gentleman from Kentucky.

Mr. **MAZZOLI**. Thank you very much, Mr. Chairman.

And welcome, Professor Briloff. We appreciate your very interesting discussion, at least I do. I think perhaps for the first time in the weeks we've been examining this whole E.F. Hutton question, and perhaps for the first time we've gone into what I would consider a very important aspect of it, and that is the public's confidence, the morality aspect. And I think there is one. We've been dealing with all of the minutia, and the details, and the very sophisticated, hair-splitting arguments about what constitutes illegal behavior or unethical conduct, and I think you have directed your statement to an aspect that I think is vitally important, which I want to get to in just a moment.

I would also like to salute you for being a person of words: you understand the language and you use it precisely and colorfully, and I enjoyed your term "euchred." Today you said that E.F. Hutton "euchred the banks." I haven't heard that term in a long time. And they, as well, "flim-flammed," which, of course, we all sort of hear about, and they "kited." I mean, that's a litany that certainly would cause any respecting businessman to sort of shrink down in his or her seat. Wouldn't that be pretty well the case?

And since you are a careful wordsman, you understand the impact of words, obviously you think that E.F. Hutton didn't do something correctly. Is that a fair judgment?

Mr. BRILOFF. I wouldn't be here if I didn't think so.

Mr. MAZZOLI. Thank you.

Let me—because I tend to agree with you, as you would imagine, but I think the problem probably goes further than the boardroom of E.F. Hutton or the boardroom of Arthur Andersen, and I think that maybe your discussion with our friend, Mr. Shaw of Florida, got into the whole aspect of professional responsibility, professional ethics, standards of conduct on the part of the accounting profession. And at one point Mr. Shaw was mentioning, my friend from Florida said something about, accepted accounting practices, provided that you can show these gross accounts of $404 million out of whack in some way or another. May I ask you this question? Perhaps you can address it rhetorically or in any otherwise.

Are we seeing an erosion of accepted accounting practices because, first of all, there is an erosion of morality in the sense of white-collar morality, and, second, because accounting firms are now intensely engaged in the mercantile production of money, they are bankrolling some of these very activities in the marketplace, they are the angel behind certain deals?

Do you think, in your professional opinion as a tenured professor, that this should cause us all some pause?

Mr. BRILOFF. It most certainly should cause all of us a great deal of pause. And, in fact, it is this very kind of question, sir, that has been front and center to the proceedings of the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, under the chair of Congressman John Dingell. And the essence of my testimony before that committee in February had to do with this pervasive phenomenon of where accountancy is going with respect to the development of our accounting precepts and the failure of effective self-regulation, and, then, questioning in good measure even the extent to which the SEC is fulfilling its oversight responsibility over the profession. So, there is no question but that it is a pervasive burden.

And the Chief Justice noted the fact that in our complex society the public must put its faith and confidence in the professions, because it is that complex. We cannot go in and make the determinations unilaterally with respect to any aspect of our existence. So, we must delegate responsibility to the presumed professionals, whether they be in accounting, whether they be in medicine, whether they be in health, whether they be in law. And we must expect from them a full and complete understanding of what the means, of what the very designation of a profession means.

Mr. **Mazzoli**. Do you think that maybe some of the newer practitioners of accountancy have lost sight of the traditions and the lofty history of the profession because they walk into firms now that are groveling for money just like the most mercantile of companies that they're out there bankrolling and being involved? I mean, do you think that maybe they, themselves, are incapable of having this high fiduciary standard that we, at least in my generation, grew up with in law, and accountancy, and medicine? Do you think that's a fact?

Mr. **Briloff**. Well, it is a very unhappy circumstance that we are relating to. I have written, over the past score of years, about my concern, and it is becoming an increasing concern, regarding, for example, the profession's loss of its notion of independence or involvement in peripheral services. We don't know just where it is that our auditing and accounting responsibility should end. So it is that we run, helter skelter, to perform whatever service it is that the client is prepared to pay for.

Mr. **Mazzoli**. Let me ask you one thing, Professor, and I appreciate this—and I know the chairman is anxious that we hear from all of our panelists. I have the highest respect for Judge Bell, as the Attorney General, as an eminent former court of appeals judge, and as a practicing lawyer, and I have no doubt that that report of his is based on things as he and his people saw them. I would have, however, been much more confident about its conclusions had I known that Judge Bell's firm, King & Spalding, I think, was very much involved with E.F. Hutton on some kind of a bond issue. If I had known that when the report came out, I would have probably had a little bit less feeling for the objectivity of that report.

Let me ask you this question in two ways: Do you think that, perhaps, Judge Bell and the auditors, for example like Arthur Andersen, if they have financial involvement with various clients that they're so-called auditing, ought to list that in a very prominent way so that the public would know; and, as you were saying to my friend from Florida, at least they ought to have a right to know what's going on? Do you think that kind of a listing, do you think that even Judge Bell fell short of the mark of objectivity and fiduciary responsibility?

Mr. **Briloff**. I will first answer it with respect to the accounting profession. I have regularly pleaded with committee after committee and with my colleagues within the profession, "Set out as part of the proxy material all of the peripheral activities, management and advisory services and the like, taxes, et cetera, that you're involved in, and tell the public the fees that you are garnering for these peripheral activities, so that we might know of potential contamination." I would, however, say that if the auditor has an important, direct or indirect, financial interest in the corporation that's being audited, that is categorically a "no-no" in our profession, and the audit should not even be undertaken as an independent audit under those circumstances.

Mr. **Mazzoli**. And my last response, and I'll yield back my time—and I appreciate the chairman's indulgence—is that my friend from Florida asked the question about CPA's are not lawyers, and, therefore, there are certain, perhaps, inabilities they have to ferret out these facts. Well, I would have to say this to kind of bring it down home, businessmen aren't lawyers either, and they sometimes are charged with check kiting and knowingly performing some kind of a number on some unsuspecting clients. So, I really, with all respect, when you see numbers like we saw floating around here, it just seems beyond any reasonable belief that some accountant, regardless of whether or not he or she is a lawyer, would not have had their antenna raised sufficiently to cause some questions.

I yield back my time, and I thank the chairman.

Mr. **Shaw**. Mr. Chairman.

Mr. **Hughes**. The gentleman from Florida.

Mr. **Shaw**. I would ask unanimous consent to place into the record at the appropriate spot, where the professor was talking about the accounting profession, the statement of the AICPA entitled, "On the Quality of Independent Audits," which was the testimony before the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce of the U.S. House of Representatives. I believe the professor made——

Mr. **Hughes**. Without objection it will be so received.

[The information follows:]

ON THE QUALITY OF INDEPENDENT AUDITS

Testimony Before the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce of the U.S. House of Representatives

AICPA American Institute of Certified Public Accountants

FOREWORD

For the second time in less than a decade, the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce is conducting hearings on the performance of the public accounting profession.

The AICPA appeared before the subcommittee on March 6. Our testimony concentrated on

- The quality improvement programs of the Division for CPA Firms.
- Actions taken to enhance auditor independence.
- Steps taken to assist smaller CPA firms.
- Improvements made in the standards-setting process.

The testimony was accompanied by a paper on the quality of independent audits that discussed

- The distinction between a business failure and an audit failure.
- The nature of audit failures and their implications for the general level of audit quality in the profession.
- The effectiveness of existing regulation of the profession.
- The standards-setting process.
- Independence.
- The performance of management advisory services for audit clients.

Because of the importance of issues raised by these hearings, we are sending a copy of our testimony to each AICPA member.

New York
March 8, 1985

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Statement of the American Institute of Certified Public Accountants Before the Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, U.S. House of Representatives, March 6, 1985

I. INTRODUCTION

Mr. Chairman, Members of the Subcommittee, I am Philip B. Chenok, president of the American Institute of Certified Public Accountants (AICPA or Institute), the national professional organization of certified public accountants (CPAs) in the United States. Its service to the profession and to the public spans almost one hundred years. Today, membership consists of over 230,000 CPAs in public practice, in industry, in education, and in government. Over the years, the AICPA has been a principal force in developing standards, educational programs, and professional publications to improve the quality of services provided by CPAs. The Institute is widely recognized as the authoritative voice of the accounting profession.

We are here today to help the committee evaluate the effectiveness and independence of audits of the financial statements of American business. In the hope that our comments might provide useful perspective for this inquiry, the Institute is submitting as part of this testimony a paper titled "AICPA Comments on the Quality of Independent Audits."

In that paper we discuss the nature of financial statements and the audit function, explain the difference between "business failures" and "audit failures," set out the elements of the existing regulatory structure, comment on the process for setting accounting and auditing standards, discuss the concept of independence, and identify certain current projects designed to strengthen audit quality. These are all matters of considerable importance and some complexity, and I commend that paper to your reading.

Rather than summarize our paper, I would like to take the time allotted to me to discuss the actions taken by the AICPA in response to concerns raised when Congress last examined the accounting profession. These concerns related to

- Whether there was a need for a federally legislated organization to regulate CPA firms that practice before the Securities and Exchange Commission.

- Whether auditors were sufficiently independent of their clients.
- Whether smaller accounting firms could compete effectively for audits of public companies.
- Whether the process for setting accounting and auditing standards should be opened to public scrutiny.

We believe the profession has dealt effectively with these matters in the intervening years.

II. ACTIONS TAKEN TO REGULATE CPA FIRMS

The AICPA Division for CPA Firms was created in 1977 to improve the quality of accounting and auditing services provided by independent public accounting firms. This initiative represents a major commitment to professional self-regulation.

The division is comprised of two sections: A Private Companies Practice Section for firms that provide accounting and auditing services to nonpublic entities and an SEC Practice Section for firms whose audit practice includes SEC registrants.

Each section has significant membership requirements, the most important of which calls for a critical quality assurance review by other CPAs of a member firm's accounting and auditing practice every three years. Reports on these reviews are available to the public. In the case of the SEC Practice Section, a firm's required response to its reviewers' written suggestions for improvement along with the suggestions themselves are also available for public inspection.

When significant problems with a firm's quality control policies or procedures are identified, the firm may be required to agree to revisits by the reviewers to determine that necessary corrective actions were taken, to submit to accelerated peer reviews, or to provide additional education for specified staff. If a specific audit engagement is found to have been performed in a substandard manner, firms are required to take appropriate corrective action, such as performance of omitted auditing procedures, correction of financial statements, or withdrawal of their audit report.

All of the activities of the SEC Practice Section of the division are under the scrutiny of the Public Oversight Board, consisting of five highly respected, independent individuals. The SEC has access to the peer review process through the Public Oversight Board, thus providing further assurance that there is appropriate recognition of the public interest in the way these activities are carried out.

As a complement to the peer review process, SEC Practice Section member firms also accept an affirmative obligation to report to the section's Special Investigations Committee any litigation alleging audit failure with respect to SEC clients.

That committee determines whether corrective steps should be taken to provide assurance of a firm's continuing ability to perform audits in conformity with professional standards. The committee is also charged with determining whether there is a need to reconsider the adequacy of existing professional standards.

The division's activities are corrective rather than punitive. Some have urged the division for CPA Firms to sanction member firms through fines, censures, and the like, to be imposed with attendant publicity.

From its very beginning, the division's emphasis has been on remedial action designed to strengthen quality control, to prevent recurrences of problems, and to correct any noted deficiencies in the practice of member firms. Formal sanctioning powers have been reserved as a means of inducing member firm cooperation in bringing about the necessary remedial action. When appropriate, sanctions are imposed by others — the SEC, the state boards of accountancy, or the courts. The division's programs are intended to complement those other aspects of the total regulatory structure, not to duplicate them.

Division members audit about 86 percent of all publicly held companies, accounting for 99 percent of the revenue reported by such companies. While this coverage is an outstanding accomplishment considering the voluntary nature of the program, division membership is expected to increase further as AICPA members and the public become more aware of its significance and of the usefulness of peer review reports. In mid-1984 the two sections began a major information program to increase public awareness of the division.

We believe the foregoing record of accomplishment adequately responds to the concerns expressed by the Congress and that there is no need for a federally legislated organization to regulate CPA firms that practice before the SEC.

III. ACTIONS TAKEN TO ENHANCE AUDITOR INDEPENDENCE

Let me now turn to auditor independence, the hallmark of the accounting profession. Independence assures that CPAs act with integrity and objectivity. Not only must the auditor maintain an independent mental attitude with respect to the entity being audited, he or she must refrain from financial interests or personal or employment relationships that would compromise the audit function. The concept of independence must be carefully guarded in a changing environment, and it must be emphasized to each succeeding generation of CPAs. I would like to summarize some of the actions we have taken in recent years to do this.

- AICPA has encouraged the formation of audit committees including outside directors and has published a booklet to assist companies in that undertaking. It is now common practice for auditors to attend annual meetings of public companies to respond to shareholder questions.

- The membership requirements of the SEC Practice Section include, with respect to SEC registrants, periodic rotation of the partners in charge of those audits, concurring review by a partner not otherwise involved with the engagement, and a report to the audit committee of any disagreement with management that, if not satisfactorily resolved, would have caused the issuance of a qualified report on the financial statements.
- The SEC Practice Section requires member firms to report to audit committees of SEC registrants the total fees received for management advisory services during the years under audit and a description of the types of such services rendered. Also, SECPS member firms are required to report, for the section's public files, aggregated information with respect to fees received for management advisory services. Finally, special attention is being given in peer reviews to the quality of the audit work performed for SEC clients where fees from MAS engagements equal or exceed audit fees.

Our paper on audit quality discusses in some detail why the AICPA believes that it would be a serious mistake to prohibit the performance of management advisory services by independent auditors. CPAs are called upon to provide these services because of their objectivity and analytical skills and their knowledge of a client's business. Moreover, no compelling evidence has been found that MAS has impaired independence or adversely impacted the quality of audits. Indeed, knowledge gained in providing these services often complements information obtained in the audit process and enhances audit reliability.

IV. ACTIONS TAKEN TO ASSIST SMALLER CPA FIRMS

The third area of concern in the earlier hearings related to the ability of smaller accounting firms to compete effectively for audits of public companies. Since then, smaller firms believe the situation has worsened as competition within the profession has increased substantially, in part because of changes made in the advertising and solicitation rules of the Institute's Code of Professional Ethics, which were necessitated by changes in the application of the antitrust laws to professional organizations.

During this period, recommendations of a special committee organized to consider the needs of small and medium-sized firms have largely been implemented. Moreover, through the division's peer review process, firms of all sizes can demonstrate that they are able to render accounting and auditing services in conformity with professional standards.

Finally, the Technical Issues Committee of the Private Companies Practice Section has been active and effective in speaking out on matters, including accounting and auditing standards, that affect private companies and the CPAs who serve them.

V. ACTIONS TAKEN TO IMPROVE PARTICIPATION IN THE STANDARD-SETTING PROCESS

Prior congressional concerns also dealt with the need for greater participation in the standard-setting process. The Institute has added three non-CPA public representatives to its board of directors, and has opened to the public the policy-making meetings of the Institute's governing Council and its senior technical committees, such as the Auditing Standards Board. Frequent meetings are held with representatives of user groups and others to keep them informed of projects in process. Press releases are issued on important developments, exposure drafts of proposed pronouncements are distributed to interested parties, and public hearings are held on controversial subjects.

Efforts have been made to encourage members from smaller firms to serve on senior committees, and limitations exist with respect to the participation of those from the eight largest firms.

VI. CONCLUSION

In the final analysis, Mr. Chairman, the financial reporting system in the United States depends on the integrity of all those involved in the process — management that reports on activities and independent auditors who objectively review those reports. The AICPA will continue to strive to maintain and improve the quality of accounting practice and independent audits. As indicated in our detailed paper, some special studies have been begun in important areas to improve audit quality and others have been under way for some time. In addition, there is an ongoing effort by the AICPA to monitor the effectiveness of auditing standards and to make changes when they are called for. Let me list our most recent initiatives:

1. Discussions are being held with representatives of other organizations to determine whether a multi-organizational effort might be useful in identifying ways to improve the prevention and detection of fraud.
2. A re-examination of the existing auditing guidance with respect to bank loan loss reserves is being undertaken.
3. A special AICPA committee is studying the relevance of the AICPA Code of Professional Ethics and the adequacy of the related enforcement machinery in today's environment. The special committee is expected to issue a draft report in the fall of 1985.
4. A task force of the SEC Practice Section of the AICPA Division for CPA Firms has been studying steps the section might take to enhance professionalism in the application of accounting standards. Such steps might include changes in the section's membership requirements and certain changes in the scope of peer review.

5. In accordance with the 1984 recommendations of a special committee that studied the structure and operations of the SEC Practice Section, the section is presently considering how the public might be made more aware of the procedures and findings of its Special Investigations Committee.

Mr. Chairman, I want to assure you and the subcommittee that the members of the AICPA are dedicated to strengthening the system of financial reporting. We recognize the paramount importance of the public interest in our work and will carefully study the record of these hearings in an effort to make further improvements. The accounting profession is committed to standards of excellence and integrity, and we believe it is deserving of the confidence of the investing public and the Congress.

AICPA Comments on the Quality of Independent Audits

A Paper Submitted With
Oral Testimony of the
American Institute of Certified Public Accountants
Before the
Subcommittee on Oversight and Investigations,
Committee on Energy and Commerce,
U.S. House of Representatives,
March 6, 1985

INTRODUCTION

Periodically, members of Congress and the Securities and Exchange Commission, among others, express concern about the quality of audits being performed by independent CPAs. Although other factors may be involved, these concerns arise when there has been a sudden upswing in the number of publicly traded companies that unexpectedly encounter severe financial difficulties or file for protection under the bankruptcy statutes. The concerns are heightened when very large companies are involved, their shareholders and credit grantors suffer heavy losses, and the financial difficulties are widely reported in the national financial press.

A combination of the frequency of such business failures, the large amounts of losses incurred, and the sudden plunge in the prestige and reputation of the major companies involved may signal that something is going awry that requires attention. This is particularly true when there is a concentration of failures in a single industry. For example, a number of banks and other financial institutions have recently failed. In earlier times, similar problems afflicted the real estate investment trust and franchising industries. When this happens, attention is frequently focused on the financial reporting by the failed entities and on independent auditors and the quality of their work.

BUSINESS FAILURES AND THE AUDIT FUNCTION

Failures of large business enterprises invariably are accompanied by multi-million dollar lawsuits against their independent auditors on behalf of shareholders and creditors. Indeed, the suits often focus on the CPA firms because they are usually the "deepest pockets" available in the financial rubble of a failed company. Asserting their reliance on the audited financial statements, the plaintiffs allege that the statements were misleading and that the auditors failed to comply with professional standards in examining and reporting on them. The extensive media coverage of these events often conveys the impression that an actual audit failure has occurred.

To be sure, while the objective of CPAs is to prevent all audit failures, auditors are human and performance failures can and do occur. But a business failure or the filing of a lawsuit or media notoriety does not necessarily mean that there has been an audit failure. Even payments made by CPA firms in settlement of lawsuits are not proof of an audit failure. Such payments may be made simply because they are less than the potential legal and other costs of defending the firm in litigation.

Businesses fail for a variety of reasons that are unrelated to the financial reporting process. Poor management, societal or technological developments, domestic and foreign competition, and changes in the economy are some of the major causes of business failures.

Investors and creditors are responsible for assessing the risk of investing in or lending to a company. Accordingly, in making that judgment, they need to consider a wide range of information in addition to the historical financial information included in audited financial statements. The quality of management, developments in the industry, labor relations, marketing and product development plans, and the state of the economy are some of the factors that may be as relevant or even more relevant than historical financial statement information. As a result, investors and creditors can make bad judgments about a company and its future prospects even though the audit of the historical financial statements is without fault.

The role of the independent auditor is not to guarantee that investors and creditors will not make bad judgments and suffer losses. Neither is it to advise users of financial statementson the desirability of investing in or lending to a company.

The proper, long-standing role of the independent auditor is to provide the public with reasonable assurance that the representations of management reflected in the company's financial statements and the related disclosures comply with generally accepted accounting principles. The independent audit should bring a trained, experienced, professional oversight to the financial reporting process and, thus, serves to deter the issuance of misleading financial statements by management.

Indeed, in a January 1985 Pace University survey of Fortune 500 and private companies, 107 of the 117 respondents indicated that they would have an annual audit by a public accounting firm even if it were not required. The most frequently cited reasons were that the independent audit imposes discipline on the entire financial system and that an independent audit is required for credibility of financial statements.

The broad question of whether independent auditors are satisfactorily fulfilling their intended role leads to a number of inquiries:

1. Do the current reports of alleged audit failures indicate a deterioration of audit quality?
2. Is there sufficient regulation of independent auditors to safeguard against negligence or lack of objectivity or integrity?

3. Would changes in the present system of establishing financial accounting and auditing standards reduce the incidence of business and audit failures?
4. Is the performance of management advisory services for audit clients impairing the independence, integrity, or objectivity of auditors?

ALLEGED AUDIT FAILURES AND AUDIT QUALITY

Professional standards require the auditor to plan his examination to search for misstatements that would have a material effect on the financial statements, but they do not call for extended auditing procedures to detect fraud unless the auditor's examination causes him to believe material fraud may exist. This is because the cost of an audit must be reasonable in relation to the expected benefits. However, auditors can and do detect fraud in the course of audit engagements. An independent auditor's standard report implicitly indicates his belief that the financial statements taken as a whole are not materially misstated as a result of error or irregularities.

As previously discussed, business failures are not caused by audit failures. Business failures may be caused, or hidden, by a material management fraud that goes undetected by the independent auditor until severe financial difficulties or some other events cause the fraud to be revealed. In these situations, notwithstanding the auditor's compliance with generally accepted auditing standards, forgery, unrecorded transactions or extensive collusion can make some management frauds exceedingly difficult if not impossible for auditors to detect.

The detection of management fraud is one of the most difficult problems faced by independent auditors, one that has received and continues to receive a great deal of attention by the profession.

Professional auditing standards have long included the concept of selective testing. Consistent with that concept, auditors rarely audit all of the transactions that compose an individual item (for example, accounts receivables) in the financial statements because the cost to do so would be prohibitive. Because of cost considerations, a sampling method is also used by the Internal Revenue Service in auditing tax returns and by the Securities and Exchange Commission in reviewing filings by registrants.

Auditors study and evaluate a company's system of internal control to decide on the nature, timing, and extent of tests to be performed. Nevertheless, it is possible for any control system to be circumvented, in which case even an audit of all transactions may fail to disclose the fraud. Thus, rather than being indicative of a general problem with audit quality in the profession, the failure to detect management fraud is more likely to be the result of the sophistication with which the fraud was carried out or the result of a human error on the part of the individual auditor. Also, to be frank, courts have concluded in rare cases that the conduct of an individual auditor was felonious. But in all of these situations, the auditing firm is as much the victim of the fraud as are the investors and creditors.

In addition to undetected fraud, there are other circumstances that give rise to perceptions of audit failure and concerns about audit quality. For example, a company, with the auditor's knowledge and consent, may have selected an acceptable accounting treatment that presents its financial condition and operating results in the most favorable light. If the business subsequently fails or encounters severe financial problems, the auditor's acceptance of that treatment is questioned in the light of hindsight.

Since these situations are not cases of oversight by the auditor, they are not "audit failures" in the sense that errors or irregularities were not detected. But some critics of the profession contend that cases involving accounting treatment questions are even more serious because they see them as involving faulty judgment or, even worse, a lack of objectivity or integrity on the part of the auditor.

Auditors do insist on accounting changes when the appropriate accounting is clear. But what accounting standard is appropriate in a particular circumstance is not always clear. Accounting standards require the application of judgment. This stems from the fact that most important items in financial statements cannot be measured precisely but have to be estimated. For example, the preparer of financial statements has to estimate the amount of accounts receivable that will not be collected because goods may be returned or customers may default, the amount of inventory that should be considered obsolete, the useful lives of property and equipment, the amounts of possible losses from such things as product warranty claims or lawsuits, and whether and how revenue should be recognized as, for example, in a construction project extending over several years.

Thus, although financial statements are presented as numbers that may appear to be precise, the amounts are and can be only reasonable approximations of the results of a company's transactions. Complete accuracy is rendered impossible by the fact that financial statements are issued at regular points in time while certain of the underlying transactions are still not complete and important events that will have an effect on those statements have not or may not yet have taken place. Therefore, the fact that an accounting judgment made at the time of the audit may be shown by subsequent events to have been overly optimistic or conservative does not mean that the auditor's and management's judgment or conduct was flawed.

Understandably, auditors sometimes differ in their judgments about the accounting treatment that is appropriate when applying accounting standards to complex transactions. Concerns arise when companies, especially those in financial trouble, take advantage of the differences in judgments among CPA firms to seek the answer most favorable to them. This practice places added pressure on auditors. But few auditors would knowingly risk such severe penalties as legal liability or loss of reputation for independence and integrity by agreeing to accounting treatments that were not consistent with their firmly-held professional convictions.

Another source of concern stems from cases where accounting measurement and disclosure standards are fully complied with and no fraud is involved, but a company unexpectedly fails. Critics generally insist that auditors should issue an explicit warning when a company is in a precarious condition.

As previously indicated, the auditor's role is to express an opinion on the conformity of the financial statements and related disclosures with generally accepted accounting principles. Those principles call for disclosure of uncertainties and contingencies in appropriate circumstances. Investors and creditors are expected to study, among other things, the financial statements and to assess the company's financial condition in the light of their own objectives and their tolerance for risk. Of course, auditors do qualify their opinions when questions about the ability of a company to continue in existence raise significant doubts about the amounts and classification of assets and liabilities. Such a qualification involves complex professional judgments and should be given only when circumstances demand.

In summary, a business failure is not the same as an audit failure, and actual audit failures need to be carefully distinguished from perceived failures. Perceived audit failures often stem from a lack of understanding of what reasonably can be expected to be achieved by audits or of the facts in a particular case. Misunderstandings of the nature, purpose, and limitations of financial statements also contribute to misperceptions that audit failures have occurred.

Actual audit failures are generally the result of honest human error on the part of individual auditors rather than a reflection of the general quality of work by their firms or the profession. Such errors may involve failing to detect material errors or irregularities or making good-faith judgments on accounting matters that are proven faulty by subsequent events.

Financial statements are necessarily only a reasonable approximation of a company's financial condition and results of operations. For this and other reasons, independent audits do not and cannot provide absolute assurance on the accuracy of financial statements. However, independent audits do provide a considerable measure of assurance that financial statements are not misleading within the context of generally accepted accounting principles. Therefore, it is important to all users of financial statements that audits be performed as effectively as possible. This is an objective not only of the SEC and of Congress, but is of prime importance to the AICPA.

REGULATION OF INDEPENDENT AUDITORS

A major question in a review of the quality of audits is whether there is sufficient regulation of independent auditors. Regulation and disciplinary machinery are generally seen as means of preventing — through the threat of sanctions — dishonesty or carelessness on the part of independent auditors. While this cannot guarantee that honest mistakes will not be made, regulation and the prospect of penalty are believed to be appropriate countervailing forces to the pressures on objectivity and integrity encountered by auditors in the marketplace. This general proposition is not disputed, but the nature and extent of regulation required and the point at which diminishing effectiveness is reached is the subject of different opinions.

The AICPA believes that the body of regulation presently in place is basically sufficient and that auditors are in fact exercising a high degree of objectivity and integrity. This is not to assert that problems do not exist or that improvements cannot be made. Indeed, the public accounting profession constantly strives for improvement. The AICPA believes that the present framework for bringing about needed improvements is adequate and appropriate to the task and that increased regulation would not be likely to yield significant improvements.

In any event, the types of losses from sudden business failures that give rise to concerns about the quality of financial statements and audits will continue to occur from time to time. Added regulation of auditors is not a solution to the problem of business failures because they stem from factors other than the quality of financial reporting and auditing. Although financial statements can provide information that may foreshadow the possibility of failure, they are but one of several tools that should be used by investors and creditors in forming judgments about the financial prospects of a company.

The AICPA's judgment about the adequacy of existing regulation is based upon many years of experience with the mosaic of regulation currently in place as described below:

1. To become and remain licensed under state law administered by state boards of accountancy, independent auditors must —
   a. Meet minimum education requirements.
   b. Pass a rigorous uniform CPA examination.
   c. Have experience in the practice of public accounting to become licensed in most jurisdictions.
   d. Show evidence of good moral character.
   e. Engage in continuing professional education to remain licensed in most jurisdictions.
2. CPAs and their firms are required to comply with extensive regulations promulgated by private-sector standards-setting bodies as well as by the Securities and Exchange Commission and by a number of other federal and state regulatory bodies. Those standards and principles, together with related interpretations and guides, constitute a body of professional literature unparalleled anywhere else in the world.
3. CPAs and their firms are required to comply with the codes of ethics of state CPA societies, state boards of accountancy, and the AICPA. Failure to do so can result in loss of membership in these organizations and loss of the state license to practice as a CPA. The codes contain requirements, among others,

relating to independence, integrity, and objectivity, and to compliance with generally accepted auditing standards and accounting principles.

4. CPA firms auditing approximately 86 percent of the publicly traded companies in the United States — which represent almost 99 percent of the annual sales of all such companies — are members of the SEC Practice Section of the AICPA Division for CPA Firms. Member firms agree to —
   a. Peer reviews of the quality controls of their accounting and auditing practices every three years. (Reports on these peer reviews are available to the public.)
   b. Second partner reviews of audits of SEC clients.
   c. Rotation of audit partners in charge of audits of SEC registrants every seven years.
   d. Extensive continuing professional education for all professional personnel, not just those who are CPAs.
   e. File annual reports with the AICPA containing key firm data. (The reports are open to public scrutiny.)
   f. Report specified alleged audit failures to the section's Special Investigations Committee, which determines whether corrective action is required by the firms involved or whether there is a need to reconsider the adequacy of professional standards.
   g. Comply with penalties imposed by the section's executive committee for failure to comply with membership requirements.

   All of the section's activities and records are open to review by an independent Public Oversight Board (POB) with its own staff. The POB appraises and issues an annual report on the section's activities and maintains close liaison with the Securities and Exchange Commission.
5. CPAs and their firms practicing before the SEC are subject to private investigations, injunctive actions, and disciplinary actions under SEC Rule 2(e).
6. CPAs and their firms are subject to professional liability lawsuits filed by private plaintiffs. CPAs may also be named as defendants in criminal actions.

The foregoing represents a formidable array of regulation that, taken as a whole, is more than adequate to cause independent auditors, in their own self-interest, to strive for professional excellence in their practices.

This is particularly true with regard to the exposure of independent auditors to lawsuits for millions of dollars of damages. No CPA or CPA firm is likely to take lightly the enormous cost in time and legal fees as well as damage to reputation that stems from being a defendant in a professional liability suit. Accountants' liability insurance is small comfort because of escalating premiums and deductible amounts (which, for large firms, can amount to millions of dollars) borne by the insured.

While CPAs are driven to perform at a high level by their professional pride, it is also true that exposure to legal action is a strong deterrent to substandard performance by independent auditors. The pressures that flow from being paid by the audited company or from competition for clients pale in significance in the light of the threat of being sued for damages in amounts that could, given the size of recent awards and settlements, put an auditing firm out of business.

If anything, the threat of liability suits may be too strong. Contrary to the belief of some, improvement in the performance of independent auditors might well flow from carefully limiting rather than expanding their exposure to legal liability.

No scheme of regulation — by firms, by peers, or by government — will ever prevent all audit failures because auditing is a human art subject to individual human error. Neither will it guarantee that all individual auditors will be objective and honest any more than all crime can be eliminated by legislation and enforcement. But the incidence of dishonesty or negligence on the part of CPAs has historically been extremely low in relation to other groups in society. The existence of a high level of integrity among auditors and the strength of the countervailing pressures embodied in the present system of regulation supports the AICPA's belief that major changes in the regulatory structure would not yield significant benefits.

In this connection, it should be noted that the AICPA has a long record of cooperation with the SEC, other regulatory bodies, and the state boards of accountancy to obtain their views and refine and strengthen the effectiveness of the current system. For example, the AICPA worked extensively with the SEC to resolve differences of opinion on the approach to peer review and reached agreement on the nature and extent of the SEC's access to the peer review process. Representatives of the AICPA Auditing Standards Board meet frequently with SEC staff to discuss projects on the board's agenda and issues needing consideration. State boards of accountancy, in connection with their disciplinary proceedings, have required certain firms to join the Division for CPA Firms and undergo peer review. Cooperation will continue.

FINANCIAL ACCOUNTING AND REPORTING STANDARDS

Any evaluation of the quality of financial reporting and the related performance of independent auditors requires consideration of the adequacy of financial accounting and reporting standards, auditing standards, and the manner in which such standards are established. Since the SEC has statutory authority to set generally accepted accounting principles (synonymous with financial accounting and reporting standards), that agency is expected to act whenever it believes that an inadequacy exists. While it has taken the initiative in some instances, the commission has historically followed a policy of looking to the private sector for the setting of standards and applying its considerable influence when that seemed necessary. Accordingly, financial accounting and reporting standards in the United States have been set primarily by the Financial Accounting Standards Board (FASB) since 1973. Prior to that time, the AICPA performed that function through its Accounting Principles Board and a predecessor Accounting Procedures Committee.

Information about the structure, function, and record of the FASB is not covered here because that body is independent of the AICPA. However, the AICPA strongly supports the FASB and believes that it has a commendable record of achievement.

The setting of financial accounting and reporting standards will always be controversial and subject to sharp criticism regardless of the body responsible and whether that body is in the public or the private sector. This is so for a number of reasons:

1. The complexity of business transactions makes the substance of such transactions — which should govern the accounting — subject to differing interpretations.
2. Standards are man-made conventions designed to achieve reasonable uniformity and comparability. Judgments, often based upon estimates, are involved in both their development and application.
3. There are differing points of view about how standards should be structured and the degree of specificity that should be followed.
4. Standards have an important impact on and are of high interest to companies, auditors, financial analysts, investors, creditors, government regulators, labor unions, and others. The conflicting interests of these diverse groups guarantee that someone's ox will be gored whenever a more restrictive standard is adopted.

As should be expected, the FASB has received its share of criticism, elements of which are often dramatically contradictory. The criticisms take the following form:

1. There are too many standards *vs.* there is not enough timely guidance.
2. Standards are too detailed *vs.* too many areas are left to judgments.
3. Too many alternatives exist *vs.* not enough alternatives exist to deal with special circumstances.

These criticisms reflect the tension between the perceived effectiveness of dealing with problems through detailed rules and the contrary need to provide guidance in a form that will accommodate changing and unique circumstances, some of which cannot be foreseen when standards are being considered.

Financial accounting and reporting standards are a framework for providing users with reliable financial information that is relevant and that meets reasonable cost-benefit tests. The problem is that what is relevant changes with circumstances, and judgments about costs and benefits are highly subjective. It should not be surprising, therefore, that the standards-setting process is the target of sharp criticism by those who disagree with or are adversely affected by a standard. In evaluating the merits of those criticisms, consideration should be given to two important facts:

1. Although there are exceptions, the quality of financial reporting by the vast majority of the more than ten thousand companies whose securities are publicly traded continues to be at a high level. Users of financial statements generally do not complain that the FASB has disregarded their needs. Indeed, the FASB often has to emphasize to users the importance of certain information, such as the effect of changing price levels on the financial condition of a company.
2. The vast majority of existing standards have been developed within the private sector in cooperation and consultation with the SEC. Nevertheless, the SEC has not been reluctant to exercise its statutory mandate by the direct issuance of standards.

In addition, the present standards-setting structure provides several advantages:

1. The substantial costs of research and due process are borne by the private sector.
2. The SEC can objectively evaluate standards issued by a private sector body. Were it to be the initial issuer of a standard, a substantial amount of its time and resources would be spent in dealing with the comments of others and in reconciling different points of view.
3. Support for standards is likely to be better if those affected by them participate in their development. The private sector is best able to foster a participatory effort.

It is for all the foregoing reasons that the AICPA believes that major changes in the present standards-setting process are not warranted.

AUDITING STANDARDS

Financial accounting and reporting standards provide a framework for the preparation of the financial statements that CPAs audit. Auditing standards govern the way in which independent auditors conduct those audits. Auditing standards are important to regulators in evaluating the general quality of audit work and to them and the courts in judging the performance of CPAs in specific audits.

The AICPA has set auditing standards for over sixty-five years, although most of the activity has taken place since 1939 and, as business has become more complex, the pace has increased in recent years. For example, between 1939 and 1972 the AICPA Committee on Auditing Procedure issued fifty-four Statements on Auditing Procedure; between 1972 and 1984, successor bodies issued forty-nine Statements on Auditing Standards. In addition, seventy-three staff auditing interpretations have been issued, and twenty-six accounting and audit guides relating to specific industries are currently outstanding.

As a result of recommendations of a Special Committee to Study the Structure of the Auditing Standards Executive Committee in May 1978, the AICPA made a number of improvements in the auditing standards-setting process. It reduced the size and changed the composition of what is now known as the Auditing Standards Board; changed its voting requirements to require 60 percent (previously 67 percent) in favor to adopt a proposed standard; opened board meetings to the public; provided compensation to board members who requested it to facilitate participation by individuals from smaller firms; and strengthened the staff. A 1983 AICPA study confirmed the continuing appropriateness of these changes.

The reconstituted Auditing Standards Board is dealing on a timely basis with auditing problems as they arise. It makes a major effort to obtain suggestions for matters that should be added to its agenda. In the seven years ended December 31, 1984, it issued twenty-eight binding Statements on Auditing Standards that cover important subjects such as quality control standards, going-concern problems, audit sampling, audit risk and materiality, and reporting on internal accounting control. The Auditing Standards Board has developed a body of standards and interpretations that are the most comprehensive in the world. In addition, ten audit and accounting guides were issued during the same period. These guides are book-length documents that help CPAs understand the problems of an industry and the accounting and reporting practices appropriate to that industry, and provide guidance on the application of auditing standards.

The Auditing Standards Board recognizes its responsibilities to the public. Its deliberations are held in meetings open to the public; it gives wide public exposure to proposals for new standards. It meets frequently with the staff of the SEC. And it conducts periodic liaison meetings with representatives of other groups, such as the Financial Executives Institute (a preparer group), the Robert Morris Associates (a user group), and the FASB, the body that sets accounting standards. The AICPA believes that the present structure for setting auditing standards is working well and is appropriate.

INDEPENDENCE

A discussion of the quality of independent audits would be incomplete without addressing the subject of independence, an attribute of CPAs essential to public reliance on audited financial statements. The concept of auditor independence precludes relationships that would be likely to impair the auditor's integrity or objectivity.

As applied to independent auditors, integrity is an element of character that prevents CPAs from intentionally committing a fault of omission or commission in their work. This does not mean that honest errors or mistakes will never occur.

Objectivity is the ability of CPAs to maintain an impartial attitude on all matters relating to the audit of financial statements. It is the quality of being able to evaluate, express, and use facts without distortion by personal feelings, interests, or biases.

The AICPA's Rules of Conduct dealing with independence are based on the criterion of whether reasonable persons, having knowledge of all the facts and taking into account normal strength of character and behavior, would conclude that a particular relationship would pose unacceptable threats to integrity or objectivity. The rules proscribe two general categories of relationships with audit clients:

1. Certain financial relationships with clients, such as any form of direct or material indirect financial interests. For example, this prohibits a CPA or any of his partners from owning any stock, no matter how little, in a company they audit or from participating in significant joint closely held investments with an audit client or its officers, directors, or principal stockholders.
2. Relationships in which a CPA has in effect become a part of management or an employee under management's control.

A CPA having such a relationship with a client is prohibited from expressing an opinion on the client's financial statements. In addition, the rules are far more extensive than any brief summary can indicate. For example, investments by a spouse or dependent person are deemed to impair independence. Also, positions held by close relatives can be deemed to affect independence.

The SEC, through its Financial Reporting Releases, has also promulgated extensive restrictions to assure the independence of auditors. The AICPA has worked closely with the SEC on auditor independence matters for many years.

CPA firms take great care to insure compliance with these independence rules. Detailed prohibitions of such things as accepting gifts or favors from audit clients are generally spelled out in written communications to all personnel, who are warned that violators will be promptly punished. Firms also go to great lengths to obtain assurance that their partners and professional staff are abiding by the prohibitions against financial relationships with clients. The peer review process of the AICPA Division for CPA Firms tests compliance with the rules on auditor independence and when violators are found — there have been some — sees that appropriate action is taken by the firm.

There are, no doubt, violations of the rules on independence that go undetected. But to the best of the AICPA's knowledge, compliance is generally at a very high level.

PERFORMANCE OF MANAGEMENT ADVISORY SERVICES FOR AUDIT CLIENTS

Management advisory services consist of a wide range of advice and technical assistance to clients, including some that are audit clients, to help them improve the use of their capabilities and resources. Concerns that providing MAS to audit clients impairs auditor independence have been raised a number of times in recent years.

Numerous studies have been undertaken because of these concerns. The most recent of these studies were by the Public Oversight Board of the SEC Practice Section in 1979 and by an independent Commission on Auditor's Responsibilities in 1978. These studies found no evidence that such services had been a cause of an audit failure or had resulted in an impairment of independence and did not recommend that prohibitions be imposed on the performance of MAS for audit clients.

Another recent study focused on the research to date, on liability lawsuits against auditors and on complaints filed with state boards of accountancy. It concluded —

> It is not apparent that a problem of any significance actually exists (K. St. Pierre, "Independence and Auditor's Sanctions," *Journal of Accounting, Auditing, and Finance*, Spring 1984).

That conclusion is further corroborated by the results of peer reviews of firms in the SEC Practice Section. The Public Oversight Board stated in its 1983-84 annual report that, based upon its tests of peer reviews, "these procedures have not surfaced any evidence that suggests . . . that performance of MAS by member firms has diluted the objectivity required in the performance of the audit function."

Those concerned about the effects of MAS on auditor independence often express the fear that audit judgments will be unduly influenced by fees earned from MAS engagements performed for audit clients. Such fees are, in fact, no more of a pressure on audit independence than the audit fee itself. Moreover, there also are strong countervailing forces, including the risk of loss of the right to practice and the exposure to liability lawsuits, that bolster independence. In addition, professional discipline and pride and the fact that a CPA firm's economic well-being depends on its reputation in the community, not on fees from a single client, are also important factors.

Some critics urge that auditors not be permitted to provide MAS services because they believe such a prohibition would enhance the quality of audits. However, the AICPA, as well as those who have intimate knowledge of how audits are carried out, believe that the opposite is true. In MAS engagements, CPAs gain an in-depth knowledge and understanding of important aspects of a business enterprise. Like users of financial statements, auditors need to be knowledgeable about the client's industry, how it will be affected by the economy, the quality of management, the effectiveness of internal systems, and similar matters. The more knowledge the auditor has, the better, because auditors need to be able to judge whether the portrayal of a company's transactions in the financial statements are reasonable in circumstances that are becoming increasingly complex.

Moreover, engaging in MAS work requires CPA firms to develop knowledge and skills in new technologies that are directly applied to enhance the performance of audits. For example, the ability to apply computer software and to deal with complex computer systems has become both a necessity and an effective tool in auditing large companies. It is doubtful that the auditing profession could develop and maintain such skills if it were precluded from providing MAS services.

Some critics argue that auditors are "auditing their own work" if they perform MAS for audit clients and that their independence is therefore impaired. This notion is conceptually flawed in a number of ways.

When CPAs provide MAS they act only as outside advisors. They cannot and do not usurp management's authority. Therefore, management must assume responsibility for evaluating, accepting, and implementing the CPA's advice, and AICPA standards require a clear understanding of this before an MAS engagement is undertaken. No responsible management, given its basic responsibility and intimate knowledge of its business, would let outsiders make its decisions for it.

In any event, in expressing opinions on financial statements, auditors are not opining on the quality of such things as the client's systems, organizational structure, or management practices, which are the types of functions on which MAS advice might be rendered.

The purpose of an audit is to have an outside party review management's representations in the financial statements. Unless auditors have, in fact, become a part of management, they are still outsiders with respect to financial statements even though they have provided MAS services to a client. The MAS services themselves have been rendered in the role of an outsider.

In summary, the AICPA believes that it would be a serious mistake to restrict or prohibit the performance of management advisory services by independent auditors. There is no evidence that MAS has impaired the independence of auditors. Moreover, imposing restrictions would remove an important source of assistance to American business. The objectivity and analytical skills of CPAs and their knowledge of a client's business, organization, and personnel gained through audits make them an ideal source of advice to management in the most cost-effective manner.

The AICPA and CPAs are highly conscious of their responsibility to guard their independence at all costs because impairment would destroy the CPA's role as auditor. The AICPA, its SEC Practice Section, and CPA firms themselves have consistently adopted rules and promoted policies designed to bolster the independence of auditors, including enforceable rules of conduct, creation of audit committees of boards of directors, attendance by auditors at shareholder's meetings, management reporting on reasons for changing auditors, CPA firm reporting to boards of directors on MAS fees from SEC clients, and periodic rotation of partners in charge of SEC audits. This is a clear record of sincere desire and dedication to protect the independence of auditors and indicates that the profession would be in the forefront of restricting management advisory services for audit clients if valid reasons for doing so could be demonstrated.

CONCLUSION

The AICPA asserts that the vast majority of independent audits are of high quality. However, audit failures resulting from human error do occasionally occur. This will be so no matter how many institutional controls or technical standards are adopted. This is not to contend, however, that it is ever appropriate to relax and cease striving for better financial reporting.

Although the AICPA does not believe that major changes are called for in the present system of regulation of the profession, in the way accounting and auditing standards are established, or in the scope of services now being performed by CPA firms, there are areas where improvements might be made. As indicated below, some special studies have been begun in important areas and others have been under way for some time. In addition, there is an ongoing effort by the AICPA to monitor the effectiveness of auditing standards and to make changes when they are called for.

1. Discussions are being held with representatives of other organizations to determine whether a multiorganizational effort might be useful in identifying ways to improve the prevention and detection of fraud.
2. A reexamination of the existing auditing guidance with respect to bank loan loss reserves is being undertaken.
3. A special AICPA committee is studying the relevance of the AICPA Code of Professional Ethics and the adequacy of the related enforcement machinery in today's environment. The special committee is expected to issue a draft report in the fall of 1985.
4. A task force of the SEC Practice Section of the AICPA Division for CPA Firms has been studying steps the section might take to enhance professionalism in the application of accounting standards. Such steps might include changes in the section's membership requirements and certain changes in the scope of peer review.
5. In accordance with the 1984 recommendations of a special committee that studied the structure and operations of the SEC Practice Section, the section is presently considering how the public might be made more aware of the procedures and findings of its Special Investigations Committee.

The AICPA believes these various activities and the record of the progress that has been made since the last Congressional hearings in 1977 demonstrate the profession's commitment to excellence and its recognition of the paramount importance of the public interest in the quality of independent audits.

Mr. HUGHES. The gentleman from California is recognized for 5 minutes.

And the Chair is going to try to comply with the 5-minute rule at this point, because we have two panels and a great deal of testimony. So, I would urge my colleagues to try to stay within the 5 minutes.

The gentleman from California.

Mr. LUNGREN. I appreciate the chairman's comments, and I know that he chose me because of my noted brevity, so I will try and——

Mr. HUGHES. I knew I wouldn't have any problems.

Mr. LUNGREN. I will try and do the best I can.

Professor, much of what you said is very interesting and illuminating. However, not knowing that much about accounting and being versed in the law, it seems to me that much of our inquiry in these hearings is to detect whether there was a lack of different participants in this whole enterprise, a lack of meeting what are considered appropriate standards, in addition to illegality.

And I note that in the testimony that's going to be given a little later by representatives of Arthur Andersen, that they cite the American Institute of Certified Public Accountants' "Codification of Statements on Auditing Standards" with respect to circumstances when an auditor discovers which he or she believes to be illegal. And they first cite a statement from the standards which says that, An examination made in accordance with generally accepted auditing standards cannot be expected to provide assurance that illegal acts will be detected.

Then they go on to cite another section of the codification, which states this, that the standards require the auditor to:

> Inquire of the client's management and consult with the client's legal counsel or other specialists as necessary, to obtain an understanding of the nature of the acts and their possible effects on the financial statements.

And that is in the case of a potential illegality coming to the view of the auditor.

My question to you is—as I understand the facts—and correct me if I am wrong—if I understand the facts, in this particular situation Arthur Andersen did look at something which appeared to be a little hazy to them. They did, then, bring this to the attention of their client's management and consult with their client's legal counsel, and, in return, got a statement assuring them of its legality.

My question is: Are there additional standards of the American Institute of Certified Public Accountants which require that Arthur Andersen go beyond that, and if so, under what circumstances?

That's the shortest question I could think of.

Mr. HUGHES. The gentleman's 5 minutes have expired, by the way. [Laughter.]

Mr. BRILOFF. We CPA's are extremely competent in the creation of CYA rhetoric; that's "cover your anatomy" rhetoric. And certainly, that which they said, to the extent that you read it, helps to cover the anatomy of the auditor. But I believe you didn't read the full commentary. To the extent that they might receive some kind of an assurance from presumptively competent counsel. And I'm not certain, in my own mind, whether Mr. Rae, under those circumstances, was a competent counsel, but I accept that.

To what extent did they, then, go back to their own counsel with a full set of facts?

If you recall what I said, even accepting the notion that as of early 1980 everything was pristine pure at E.F. Hutton as far as cash management is concerned—and Judge Bell made clear that under the Sullivan regime things were reasonably good, it's only when they got rolling aggressively in subsequent years—the point I'm making is, to what extent did Arthur Andersen, being alerted to the problem, then come back to presumptively competent counsel? To what extent did they go back to their own counsel? To what extent did they, then, share even their concern about legality and illegality with the audit committee?

Because as it goes further, the statement then says, to the extent that they have continuing concern, that they then have the responsibility of going to the highest levels where something could be done, and if they are not satisfied that corrective action has been taken, to walk away from the engagement.

Mr. LUNGREN. I guess the crux of my question is: Do the standards require, the standards that are currently acceptable in the accounting community, do they require the accounting firm to take action, to go to independent counsel, if they assume that they are talking to competent counsel, that is the house counsel, of their client?

Mr. BRILOFF. The answer is that they are being extremely naive if they accept as the last word the word of house counsel who is there to protect his own neck, his own turf, who is a member of the board of directors, who knows that if he is going to get along he's got to go along.

Mr. LUNGREN. I hate to interrupt you, but my question is this. All I'm trying to find out is, what are the standards?

If what you're telling me the standards are insufficient and we ought to change the standards——

Mr. BRILOFF. No.

Mr. LUNGREN [continuing]. Then that's something I'd like to know.

Mr. BRILOFF. No. I'm telling you that the standards, if you read that further, is that he has to satisfy—the auditor has to satisfy—himself that corrective action is not necessary, assuming for the moment that he finds everything is legal. Or if he finds, on continuing inquiry, that the illegality prevails, then he does have the direct responsibility of walking away from it.

Mr. LUNGREN. The reason why I ask you this is, the standards, as they are stated here—and I accept that these are the standards unless someone can correct me—says that in those cases where there's a potential illegality, you are to consult with the management and the client's legal counsel. And my thought there is, if you're saying from the very beginning that counsel has a necessary conflict of interest and you shouldn't rely on that person anyway, then what you're telling me is that these standards are inadequate——

Mr. BRILOFF. No.

Mr. **Lungren** [continuing]. Because they don't recognize the inherent conflict that is there.

Mr. **Briloff**. No, I'm not telling you that at all. I'm prepared to go entirely on the standards, but, mind you, not on one paragraph. Remember, our standards refer to the general standards of the auditor. He or they must be informed persons, well trained and aware of their responsibility. There are standards of field work that are called for, which means to probe and to inquire as to the nature and extent of the potential illegalities.

And then there are the standards of reporting, where, for example, they are still of the concern—and, mind you, if Arthur Andersen, having probed all of these transactions fully and directly felt all along and felt right through 1982, 1983, 1984, that these transactions were legal and if they are prepared to say that, then again I say, they ought to resign from the accounting profession.

Mr. **Hughes**. The gentleman's time has expired.

I might also point out to the gentleman in the memorandum which I know the gentleman has, of March 7, 1980, one of the things that Arthur Andersen indicated that they would do, in fact, Joe Miller indicated that he would discuss the matter with Arthur Andersen partners; then, whose clients include major money center banks, to ascertain what the banks' point of view is.

And I might say that Mr. Sullivan, who was then the money manager and was just ready to leave E.F. Hutton, points out that the E.F. Hutton transactions were above board. And, in fact, he states—and this is at the top of this memorandum—that several banks, Chase Manhattan, for example, have requested Hutton actually to increase the scope of their activities.

Mr. **Lungren**. Yes, they did.

Mr. **Hughes**. Well, they did, but it was done without their knowledge, obviously.

But in any event, the fact of the matter is that in the memorandum which was prepared by Arthur Andersen, they do indicate that they intend to pursue further, not just accept Mr. Rae's opinion.

The gentleman from Connecticut is recognized for 5 minutes.

Mr. **Morrison**. Thank you, Mr. Chairman. I'll try to be brief.

First, I understand one thrust of your testimony to be that Arthur Andersen did not discharge its responsibility in fully informing the public with respect to what was going on in this area; in other words, that the denomination "checks and drafts payable" without further elaboration did not inform the public and certainly did not disclose what Arthur Andersen knew. And that was one major thrust of what you said. Do I understand that correctly?

Mr. **Briloff**. Yes, sir.

Mr. **Morrison**. And I want to move to the area of internal control and internal regulation that one would expect from the outside auditors.

One of the problems of this investigation is that no one seems to have known anything at an important time in order to prevent these events from occurring or discover them. Now we have that everyone agrees, apparently, that there was something that's called "excessive overdrafting," leave aside whether we call that "kiting" or whatever.

Isn't it true that if Arthur Andersen was doing its job, that one of two things has to be true: either the management had to be informed of what these practices were—and I mean the top management, both the internal and the external management, or else Arthur Andersen did not, in fact, do its job with respect to probing what was going on? Aren't we led to one of those two conclusions?

Mr. BRILOFF. I can't help but be led into just that conclusion; essentially, again, the failure to comprehend fully the deterioration in the internal control procedures that prevailed at E.F. Hutton. As it turns out it seems as though everyone there in the upper echelons was operating in his own cell without communication, and this is a circumstance of the organization of the corporation and the functioning of the corporation that should have signaled a serious, critical question regarding the internal control procedures; which, at the very least, should have been a subject of important and extensive and elaborate dialog between the independent auditors who were apparently the only ones to whom the independent audit committee could possibly look under these circumstances, the dialog between the independent auditors and the independent audit committee. At least this is where it should have surfaced.

And the point where I was quoted correctly in the September 4 Washington Post article, I can't help but feel that if Arthur Andersen had made known to the three members of the independent audit committee just what it is that was going on, under the rubric of "cash management" or "cash concentration," I can't help but feel that these three persons, naive though they may have been in sophisticated business, nonetheless, would have done something to blow the whistle. I just can't help but sense that as part, I must say, of my idealistic vision of persons in responsibility.

Mr. MORRISON. If we were to accept the statement from Mr. Fomon, the chairman of E.F. Hutton, and other top management officials to this committee, that they've now discovered that the internal auditing controls within the corporation were inadequate, if Arthur Andersen were doing its job over this entire period, when, apparently, this was going on, 5 or 6 years, shouldn't that have led to a qualified opinion at some point?

Mr. BRILOFF. You will undoubtedly hear from Arthur Andersen, as Judge Bell made clear in his report, that the essential responsibility of the independent auditor regarding internal control is to satisfy himself, or itself, or herself, regarding the financial statements. Now, the point I am making is, that as an incident to the fulfillment of their audit, they saw—and again, I come back to the March 1980, et cetera and so on, and the fact that this is a part of cash in the ledger and the books and the bank reconciliation statements—they saw what it is that was going on. They must have seen the fact that there were calls because of the fact that there were overdrafts that had to be covered and they had an elaborate procedure for covering. They must have seen all of this. And then, not to have confronted the internal control people concurrently with themselves to the independent audit committee, because I have nowhere else to turn to, at least as the initial focus, not to do that they were irresponsible in the fulfillment of their independent audit role.

Mr. MORRISON. Thank you, Mr. Chairman.

Mr. HUGHES. Professor, Mr. Fomon said, in his testimony before this subcommittee, and I quote:

"We did not."

Mr. BRILOFF. You think you've answered that fully?

Mr. HUGHES [continuing]. To the gentleman from——

It was their responsibility to put in place the internal pitfalls.

Mr. BRILOFF. Certainly, to the extent that they saw, and undoubtedly saw. I'm not even saying should have seen, I'm saying they saw. And they saw the fact that these internal controls procedures regarding cash management were not fully and effectively in place. They should, at the very least have confronted, again, the internal audit people before the independent audit committee of the board of directors, and to that extent, at least, have fulfilled that——

Mr. HUGHES. Well, Arthur Andersen is going to be able to respond; and they have a lot to respond to, because some serious charges have been made. And I think that that's central, really, to the issue, as far as Arthur Andersen is concerned. I'm not so sure that I yet subscribe to the belief that Arthur Andersen was not satisfied that there was that kind of abuse. I'm interested in hearing from them as to what followup there was. That is something that they have to respond to.

The gentleman from Florida.

Mr. SHAW. Mr. Chairman, as a followup to what you were just saying, I think we have to look at this in the context of time.

Now, Professor, as I understand, you said back in 1980 everything was legal and up above board. Now, as I also recall, this is when they asked the general counsel for the opinion. Am I incorrect on that?

Mr. BRILOFF. Well, you took one phrase of what I said. I said I'm prepared to accept the fact that they were satisfied in early 1980, when they were doing the 1979 audit, when Mr. Sullivan was in charge; but, the point I made, recognizing as an incident to the 1979 audit that something aggressive was going on.

Then, as my prepared statement said, as I believe I testified several times this morning, when they did the 1980 audit in early 1981, what did they do then with respect to the excessive situation that they saw a year before? When, in 1982, they did the 1981 audit, what did they do? In 1983, when they saw the 1982 audit, what did they do? In other words, I was——

Mr. SHAW. Professor, the numbers are not out of line. The company, during that period of time, grew by some 300 percent and the overdrafts only grew by around 60 percent; so you're defeating your own argument.

Mr. BRILOFF. Oh, no. No, I'm not.

Remember, I said, in answer to another question, that the numbers that might be there, growing 30, 60 or 80 or 100 percent or 2 percent or no percent, that might have gone down, are yearend numbers. I'm talking about the nature of the procedures that were involved. I do not know, from the March 7, 1980 memorandum, precisely which procedures Arthur Andersen—we're concerned about. But now, if we knew precisely the procedures that they confronted Mr. Sullivan and Mr. Rae with, and then determine what it is that they saw 1, 2, and 3 years later as to the procedures that were being followed. In other words, maybe there was no chaining, maybe there was no crisscrossing, maybe there was none of this kind of miscoding of checks and other kinds of machinations of kiting as of 1979, but they saw something that was wrong.

What did they do to follow through?

Mr. **Shaw**. But they already had a legal opinion on that something from 1980, and you say you're prepared to say that that was done correctly? I'm not, but you say you're prepared to say that it was legal then. Well, then, if it was legal then, they asked legal counsel, they were satisfied with the answer, and you're prepared to say it was legal, then you would go back—then go back to Mr. Lungren's question——

Mr. **Hughes**. We're getting off on a tangent. I didn't hear the witness say that, to begin with. The witness said "working on the assumption that it was legal." And you can't read this memorandum of March 7, 1980, and not come away with the feeling that Arthur Andersen knew, on March 7, 1980, that there was something wrong. They weren't sure whether it was legally wrong. They asked for an opinion, they got a snow job from Mr. Rae. They had to be on notice at that time, when he wouldn't reduce it to writing, that there was something wrong.

And, in fact, Arthur Andersen very clearly indicates that they're going to follow up, and the question is, Did they follow up?

We're talking about 113 branches that were overdrafted. Each one of these branches had a checkbook to write on a special account in New York to cover everyday overdrafts. And it just defies logic that there wasn't a followup, but Arthur Andersen will have an opportunity to explain that.

You know, to suggest that, in fact, it was legal, I'm not prepared to say it was legal back in 1980. I think Mr. Rae, you know, who was certainly part of corporate management at that point, knew exactly what was going on. He knew it was wrong. He refused to give Arthur Andersen an opinion, a legal opinion in writing. And Arthur Andersen had a responsibility, in my judgment—and they'll be able to respond to this—to follow up on that.

Mr. **Shaw**. I agree with you, Mr. Chairman, but what I was trying to do was to get the witness to respond. And then he was using as a basic premise that what they were doing in 1980 was wrong. And then——

Mr. **Briloff**. Yes; but Mr. Shaw, you then went ahead and, without knowing it, and somehow or other distorted what it is that I said.

I might have gone to the doctor in early 1980 and he found me in absolutely perfect health. And now, then, if I go to him in 1981, 1982, 1983, and somehow or other I drop dead from a heart attack that he should have seen on an EKG in 1983, but he says, "In 1980 I found him in perfect health, what are you complaining about to me?"

Mr. **Shaw**. Professor, I was told by my doctor that one of the most common first symptoms of heart attack is death.

Mr. **Hughes**. We are now into the health care field. I knew we would arrive there. [Laughter.]

I keep telling staff we have to keep this hearing focused, and I see we've lost.

Professor, you have been very, very helpful to us. The very fact that members had so many questions and have kept you so long I think is indicative of how we value your testimony. We thank you very much for sharing these insights with us, and we wish you well.

Mr. **Briloff**. Thank you very much.

Mr. **Hughes**. The next witnesses will be appearing as a panel. The panel consists of Mr. Philip R. Peller, Mr. Joel E. Miller, and Mr. Richard E. Flowers. Mr. Peller is the regional director of accounting and audit practice for Arthur Andersen & Co. He's vice chairman of the firm's U.S. Committee on Professional Standards, which reviews accounting and audit standards, and develops firm-wide policy. Mr. Miller is the audit partner in charge of the Financial Services Group for the firm's New York office. He was the partner in charge of the Hutton group auditing engagement for the audits of 1970 through 1982. Mr. Flowers is an audit partner of the firm's New York office, specializing in stock brokerage and banking industries. He has been the audit partner in charge of the Hutton group audits performed by Andersen for 1983 and for subsequent years.

Gentlemen, on behalf of the Subcommittee on Crime, we welcome you here today. I apologize for the length of the previous testimony. We had expected to have this panel completed by this time.

Let the record indicate that pursuant to clause 2 of rule XI of the Rules of the House of Representatives, copies of the Rules of the Committee on the Judiciary and clause 2 of rule XI of the Rules of the House of Representatives have been made available to the witnesses and are available at the counsel table, right in front of you there.

Under clause 2(k)3, rule XI, you have a right to have counsel assist you, if you desire, during this morning's proceedings. Are you accompanied by counsel this morning?

Mr. **Peller**. Mr. Chairman, accompanying us this morning, on my far right, is Mr. Michael Nemeroff, counsel with Sidley & Austin, counsel to Arthur Andersen & Co.

Mr. **Hughes**. Mr. Peller, Mr. Miller, Mr. Flowers, will you stand at this time. We're going to put you under oath.

[Witnesses sworn.]

Mr. **Hughes**. We have your statement, which is rather comprehensive, which without objection will be made a part of the record, and we hope that you can summarize for us. We've all read your statement, as a matter of fact.

TESTIMONY OF PHILIP R. PELLER, REGIONAL DIRECTOR OF ACCOUNTING AND AUDIT PRACTICE, ARTHUR ANDERSEN & CO., ACCOMPANIED BY JOEL E. MILLER, AUDIT PARTNER IN CHARGE OF THE FINANCIAL SERVICES GROUP OF THE NEW YORK OFFICE; RICHARD C. FLOWERS, AUDIT PARTNER IN CHARGE OF THE FINANCIAL STOCK BROKERAGE AND BANKING INDUSTRIES; AND MICHAEL A. NEMEROFF, ESQ., SIDLEY & AUSTIN

Mr. **Peller**. Thank you, Mr. Chairman.

Good morning, Mr. Chairman and members of the subcommittee. My name is Philip Peller and, as indicated, I am a partner in Arthur Andersen and a regional director of our accounting and audit practice. In that capacity I consult on technical matters with audit partners, managers, and staff in five of our offices, including New York.

The New York office performed our audits for the E.F. Hutton Group.

With me are Mr. Joel Miller, and Mr. Richard Flowers, Arthur Andersen audit partners in charge of recent Hutton audits, Mr. Miller during the period 1978 to 1982, Mr. Flowers for 1983 and subsequent audits.

Arthur Andersen recognizes the important role of auditors in maintaining the integrity of our country's financial system. We take our professinal obligations most seriously. For this reason, we welcome this opportunity to discuss our audits of the E.F. Hutton Group and to answer your questions.

The E.F. Hutton Group is a publicly owned company registered with the Securities and Exchange Commission. It is the largest of several wholly owned subsidiaries. E.F. Hutton & Co. is a registered broker dealer, regulated by various Federal and State agencies.

We have audited the Hutton Group and its broker dealers since 1969. Our testimony today covers only those aspects of our 1979 through 1984 audits that relate to Hutton's cash management practices.

Our audits were performed in accordance with generally accepted auditing standards. The financial statements complied with generally accepted accounting principles, and fairly presented the company's financial position and results of operations. The statement also appropriately disclosed on the base of the balance sheet the book overdraft amounts outstanding at the end of each year.

If I might summarize the more significant steps we took during our audits with respect to Hutton's cash management practices:

First, we recommended reporting and disclosure of book overdrafts as liabilities on the face of the balance sheet in each year from 1979 through 1984. This is fully consistent with professional accounting literature and current practice. The separate disclosure of drafts and checks payable, particularly when compared to unrestricted cash balances, should have alerted users of the financial statements, including regulatory agencies, that Hutton's cash management system used the float that exists between the time when a check or draft is issued and when it clears the bank.

Second, we independently focussed on the legality of the overdrafting practice in connection with our 1979 audit, and promptly brought the issue to the attention of the appropriate Hutton Group senior executives. These included both its chief financial officer and general counsel, both of whom were members of the board of directors. We received an opinion from the general counsel that Hutton's cash management practices were legal.

Third, as part of our normal audit procedures, each year we confirmed directly with numerous banks information about Hutton's account balances and other banking arrangements. Not a single bank made any comment to us about Hutton's cash management practices or expressed any concern about overdrafting.

Now let me cover each step in a bit more detail.

First, we made appropriate inquiries and followed them up during our 1979 audit. Before 1979, Hutton had used drafts as its primary method of paying customers and vendors. During 1979, Hutton changed from using drafts to checks for substantially all disbursements. Because drafts differ from checks, we concluded that the company's prior caption, "drafts payable," would not adequately describe the situation at year-end 1979.

Further we noted apparent similarities between Hutton's cash management procedures and those of the TI Corp., as described in press reports of a 1976 case involving overdrawn bank accounts. Consequently, we initiated the following specific actions:

In late February 1980, we met with Mr. Thomas B. Lynch, the Hutton Group's chief financial officer, who is a member of the board of directors and the executive committee. Mr. Lynch was our primary contact for audit matters. We recommended to him that the financial statement caption, "drafts payable," be expanded to properly describe checks issued and outstanding at year-end in excess of related book balances.

Mr. Lynch agreed to change the caption to "drafts and checks payable."

At the same meeting with Mr. Lynch, we gave him copies of the Wall Street Journal clippings about the 1976 indictment and no-contest plea by TI Corp. We also raised questions about the propriety of the company's cash management procedures. At our urging, Mr. Lynch called Mr. Loren Schecter, vice president and assistant general counsel, to discuss the legality of Hutton's cash management procedures.

Shortly thereafter, we contacted Mr. Thomas Rae, executive vice president and general counsel, and provided him with copies of the clippings about TI Corp. He agreed to arrange another meeting, at which Mr. William Sullivan, the vice president in charge of money mobilization, would make a full presentation on Hutton's practices, and Mr. Rae would resolve the legal issue.

The followup meeting with Mr. Sullivan and Mr. Rae was held about a week later. Also present from the Hutton Group were Mr. Michael Castellano, controller, and Mr. Laurence Volpe, assistant controller. Mr. Miller, the audit partner who is with me today, attended along with other engagement professionals. At the meeting, which lasted nearly 3 hours, Mr. Sullivan described the company's cash management system. Mr. Rae then explained that Hutton was in compliance with the law because they had the means to make ultimate payment.

Mr. Sullivan further pointed out that the company was aboveboard in its dealings with the banks, and that the banks were fully aware of these transactions.

At the conclusion of the meeting, we asked Mr. Rae to put his opinion in writing. While Mr. Rae declined to render a written opinion, he repeated that the banks were fully cognizant of Hutton's procedures, that what Hutton did was an accepted banking practice, and that there was no question about its propriety.

We did not insist upon a separate legal opinion from Mr. Rae because, based upon our dealings with him over many years, we had confidence in his professional ability and integrity. Moreover, his oral opinion and his analysis supporting that opinion were rendered at the end of a long meeting organized specifically to resolve our questions about the cash management system, a meeting other Hutton Group executives attended.

Furthermore, we received a management representation letter in connection with our 1979 audit. It specifically indicated, among other things, "There are no violations or possible violations of laws or regulations whose effect should be considered for disclosure in the financial statement or as a basis for reporting a lost contingency." The letter was signed by senior executives and financial officers of the Hutton Group.

We believe our prompt followup with the Hutton Group's senior management, including the general counsel, fully complied with professional auditing standards. Not only did we follow them, but it was our alertness to the situation of TI Corp., a totally unrelated company, that raised the question about Hutton's cash management procedures in the first place.

Now let me turn to another point: The disclosure of drafts and checks payable as a liability on the balance sheet. There have been some recent discussions about the Hutton Group's use of the balance sheet caption, "drafts and checks payable." We believed at the time of our 1979 audit, as we do today, that including this caption on the face of the balance sheet prominently and accurately displayed the company's book overdraft position. The balance sheet disclosures of drafts and checks payable, particularly when compared to unrestricted cash balances, should have alerted users of its financial statements, including regulatory agencies, to the full extent of Hutton's book overdrafting. Not only was the disclosure made in the Hutton Group's consolidated financial statements, but it also appeared in the separate financial statements filed by the broker dealers subsidiary, with the SEC. These disclosures clearly indicated that Hutton was using a noninterest bearing source of funds, drafts, and checks payable, to finance its business, much as accounts payable to suppliers represents a similar source of noninterest bearing financing.

The classification of a book overdraft as a liability has been addressed consistently in the accounting literature. Our written statement cites textbooks covering three decades, all of which agree that book overdrafts should be reported as liabilities. Consistent with that literature, the Hutton Group adopted the most conservative practice of determining book overdrafts on an account-by-account basis. Current accounting practice also supports this as an appropriate accounting treatment. Our computerized search of the financial statements of almost 4,000 SEC-registered companies shows that 47, including 27 whose securities are listed on the New York Stock Exchange, use the terms "check payable," "checks outstanding," or "outstanding checks," to describe a book overdraft position. In a significant majority of those instances, the companies included the overdraft in accounts payable, or another balance sheet caption, without the same prominence the Hutton Group gave to its overdraft position.

Mr. **Hughes**. I wonder if I can just interrupt you here. We have a vote in progress, and we're going to recess for just a few minutes. My colleague, Ron Mazzoli, will hurry and get back, and he'll resume the hearings. It is my intent to continue hearings until about 12:45, at which time I expect a break until 2 o'clock this afternoon. Members have another briefing at 1:30 that we have to go to.

So it's our intent to continue the hearings until 12:45, and to resume the hearings at 2 p.m. sharp.

The hearing stands recessed.

[Recess.]

Mr. **Mazzoli** [presiding]. Let's have a little order in the room, please, and we'll proceed with the testimony.

Chairman Hughes has asked that we proceed with receiving your direct statement, and then we will adjourn for a brief lunch and come back at 2 p.m. for the questions and the aftermath. So if you will proceed with your statement, please.

Mr. **Peller**. Thank you, Mr. Mazzoli.

Current accounting practice also supports the use of book overdrafts as an appropriate accounting treatment. Our computerized search of the financial statements of almost 4,000 SEC-registered companies shows that 47 of them, including 27 whose securities are listed on the New York Stock Exchange, use the terms, "checks payable," "checks outstanding," or "outstanding checks," to describe a book overdraft position. In a significant majority of those instances, the companies included the overdraft in accounts payable or another balance sheet caption without the same prominence the Hutton Group gave to its overdraft position.

We have attached to our written statement a schedule that shows those companies and relevant data about them. It shows that many large companies reported book overdrafts as liabilities in financial statements that numerous well-known accounting firms reported upon.

Using captions such as "drafts payable" or "drafts and checks payable" to describe a book overdraft position is particularly prevalent in the brokerage industry. A review of recent audited financial statements on file with the SEC from 47 of the 50 largest broker dealers in terms of capital shows that close to 40 percent use such balance sheet captions. In almost every one of these cases, the book overdraft amount exceeds considerably the unrestricted cash balance shown in the financial statements. Our written statement includes a list of these companies.

Indeed, the practice is apparently so common that the model balance sheet in the 1985 AICPA broker dealer audit guide shows drafts payable significantly exceeding cash.

Now let me turn to our audit work in the years after 1979. During this period we continued to consider the effects of Hutton's overdrafting practices. From 1979 through 1984, drafts and checks payable decreased in importance in comparison to other items on the balance sheet. For example, while the amount of Hutton's drafts and checks payable——

Mr. **Mazzoli**. Mr. Peller, let me with respect, interrupt you for just 1 second.

I said I wasn't going to ask questions, but I'm intrigued by what you were just saying, that you checked with 47 of the 50 brokerage dealers and all had something like this. I mean, is it possible—and I ask this respectfully—that if enough people do something, even if it's wrong or questionable, or illegal or unethical, or it skates the line or gives the benefit of the doubt to flim-flamming, that that then becomes a standard practice? Where are we in that type of a thing?

Mr. PELLER. Mr. Mazzoli, from our perspective, the notion that companies reflect book overdrafts in their financial statements should not—and I don't think our testimony's intent in the case—that that, in and of itself, represents an illegal practice. It represents the practice of issuing checks for more than one's bank balance—for more than one's book balance in reflecting that amount as a liability.

Mr. MAZZOLI. That's kind of interesting because, of course, I may look at it very simply and unnecessarily simplistically and what have you, but from where we come from, if you write a bad check, which is, basically speaking, a check that you don't have funds to cover, which essentially is what I think all this sophisticated accounting says, writing checks without money to cover them, that's not a good thing. And they say that if you do that long enough, you know, your next visit's to the slammer, or somebody will have retribution.

Isn't that what's going on here? I mean, these people were writing checks, knowingly and in a very orchestrated way, to the tune of hundreds of millions of dollars, without funds to cover them. And they were being certified as being very well within the standards of the profession. They were being sanctified and sent on their way to do it more.

Mr. PELLER. The concept, in going back to the memorandum that was discussed earlier this morning, the 1980 memorandum—the primary legal attendant that was put forward to us at that meeting was the notion of means to pay. E.F. Hutton, as a company, as a financial services company, has in its financial statements significant liquid assets, Government securities, Treasury bills and the like. They also had very extensive lines of credit available——

Mr. MAZZOLI. In other words, are you saying that, if I know that I have a car that I could liquidate, or that I have some stocks and some safety deposit box which, if need be, I can liquidate to cover this check, that that's not a bad thing to do then, to write a check without funds?

Mr. PELLER. I think in terms of what's good or bad, I think we from the accounting perspective look to the legal profession to provide us with guidance in that area. The practice seems to be very broad.

Mr. MAZZOLI. Well, I haven't heard that from the legal profession so much that it looks like it's standard, first standard in the profession, which means that probably it will end up doing it. And second, there is some kind of example in your AICPA illustration or model. I mean, I haven't heard it—because Rae himself wouldn't sign anything. I mean I do recall you call it an opinion, but he wouldn't sign this so-called opinion, which, again, should have given somebody pause or raised a few concerns.

But anyway, I want you to proceed. I think it's an interesting point because you saw how the drift of testimony is today——

Mr. **Peller**. Yes, sir; I did.

Mr. **Mazzoli** [continuing]. Which is to say that we wonder if, with all the money laundering that's going on in which bankers with the most elegant of Saville Row suits and smelling of cologne and, you know, the whole thing, are out there turning their head away from obviously what's a mischievous practice. We're seeing within the boardrooms people doing things which, for the average American, would be eminently a ticket to the slammer, and they get away with it because it's part of the whole charade that we deal, to try to handle the flow, try to get away with it—trying to beat the bank at its own game is essentially the case.

And so I think what we're saying is that we wonder if there is a kind of pervasive lack of awareness again of the fiduciary responsibilities that we all, as professionals, bear to our clients and then eventually, as Professor Briloff said earlier, to the public. I mean, that's really part of where we are kind of grappling around.

But anyway, if you'd proceed, I'd appreciate it.

Mr. **Peller**. Thank you.

I now intend to talk about our audit work in the years subsequent to 1979. During this period we continued to consider the effects of Hutton's overdrafting practices. From 1979 through 1984, drafts and checks payable decreased in importance in relation to other items on the balance sheet. For example, while the amount of drafts and checks payable grew by 52 percent in that period, total assets and liabilities other than subordinated debt each grew by more than 350 percent.

During each year's audit, we continued to follow audit procedures in the cash area, similar to those followed in prior years. In addition, as the various investigations evolved, our audit work expanded to consider the potential effect of these investigations on the financial statements. Our focus was principally appropriate disclosure and the adequacy of litigation reserve. Among other things, we discussed the grand jury investigation with the general counsel and the chief financial officer. In all years, the general counsel gave us a legal representation letter indicating that the ultimate effect of all claims, law suits and contingent liabilities would not result in any material adverse effect on the company's financial condition.

Each year, we also received a representation letter from the Hutton Group's management. Among other things, it advised us that they were not aware of any violations of law that should be considered for disclosure in the financial statements.

Moreover, each year, we confirmed directly with numerous banks information concerning bank balances, outstanding loans to Hutton, lines of credit, and compensating balance arrangements. In fact, throughout this 5-year period, we received over 500 separate confirmations for more than 100 different banks. Not a single bank, in responding to all of our confirmation requests, made any comments to us about the company's cash management procedures or the adequacy of its compensation. Nor did any bank express any concern about Hutton's overdrafting.

At this point we'd be pleased to answer questions of your subcommittee.

[The complete statement of Mr. Peller follows:]

PREPARED STATEMENT

OF

PHILIP R. PELLER

ARTHUR ANDERSEN & CO.

BEFORE THE

UNITED STATES HOUSE OF REPRESENTATIVES

SUBCOMMITTEE ON CRIME

OF THE

COMMITTEE ON THE JUDICIARY

OCTOBER 3, 1985

Mr. Chairman and Members of the Subcommittee:

My name is Philip Peller. I am a partner in Arthur Andersen & Co. and a regional director of our accounting and audit practice. In that capacity, I am responsible for consulting on technical matters with audit partners, managers and staff in five of our offices, including the New York office where I am resident. The New York office performed our audits of The E. F. Hutton Group Inc. With me are Mr. Joel Miller and Mr. Richard Flowers, the Arthur Andersen audit partners in charge of the Hutton audits for the years 1978 to date. Mr. Miller served in that capacity during the 1978-1982 audits, and Mr. Flowers assumed that role for the 1983 and subsequent audits.

Our firm, founded in 1913, is part of an international public accounting organization that has 214 offices, 77 of them in the United States. The Arthur Andersen Worldwide Organization is made up of more than 33,000 people, of whom nearly 2,000 are partners and over 23,000 are managers and professional staff. Our audit practice in the United States -- which lies at the heart of our business and professional reputation -- ranks largest among the "Big Eight" accounting firms.

Arthur Andersen & Co. recognizes the important role auditors play in maintaining the integrity of our country's financial system. We take our professional obligations most seriously. For this reason, we welcome this opportunity to present our views concerning our audits of The E. F. Hutton Group Inc. and to answer this Subcommittee's questions. We pledge our complete cooperation with the Subcommittee in its inquiry.

The E. F. Hutton Group Inc. (Hutton Group) is a publicly-owned company registered with the Securities and Exchange Commission. The largest of several wholly-owned subsidiaries is E. F. Hutton & Company Inc. (Hutton), a registered broker-dealer, regulated by various Federal and state agencies. We have been the auditors of the Hutton Group and Hutton since 1969.

On May 2, 1985, Hutton entered into a plea agreement with the Department of Justice under which it pleaded guilty to 2,000 counts of mail and wire fraud. The plea acknowledged abuses of its cash management system during 1980-82. The company agreed, among other things, to pay a $2 million fine and make restitution to banks in accordance with specified criteria. Our testimony today covers only those aspects of our audits of the Hutton Group's financial statements that relate to Hutton's cash management practices.

Before we begin to discuss these specific audits, it may be useful to place them in the context of audits in general. An audit is an independent examination of an entity's financial statements for the purpose of expressing an opinion on the fairness of those statements. The financial statements themselves are prepared by the company from its books and records. The auditor provides reasonable assurance that the entity's financial statements fairly present its financial position and results of operations in accordance with generally accepted accounting principles. An auditor does not review every transaction; the millions of transactions that are recorded in the books and records of a large company each year make this impossible. Instead, an auditor uses selective testing, focusing on the fairness of the financial statements taken as a whole.

All of our audits of the Hutton Group's financial statements for the years 1979-1984 were performed in accordance with generally accepted auditing standards. For each of those years, the financial statements complied with generally accepted accounting principles and fairly presented the company's financial position and results of operations -- including appropriate disclosure on the face of the Hutton Group's balance sheet of the book overdraft amounts outstanding at the end of each year.

The more significant steps we took during our audits, with respect to Hutton's cash management practices, are summarized below:

o We recommended reporting and disclosure of book overdrafts as liabilities on the face of the balance sheet in each year from 1979 to 1984. The separate disclosure of drafts and checks payable (particularly when compared to unrestricted cash balances) should have alerted users of the Hutton Group's financial statements, including regulatory agencies, that Hutton's cash management system was using the float that exists between the time when a check or draft is issued and when it clears the bank.

o We independently focused on the legality of the overdrafting practice in connection with our 1979 audit, and promptly brought the issue to the attention of the appropriate Hutton Group senior executives. These included both its Chief Financial Officer and General Counsel -- both of whom were members of the Board of Directors. In this connection, we received an opinion from the General Counsel that Hutton's cash management practices were legal.

- As part of our normal audit procedures, each year we confirmed directly with numerous banks with which Hutton did business information regarding account balances and other banking arrangements. Not a single bank made any comments to us regarding Hutton's cash management practices or expressed any concern about overdrafting.

Each of these steps will be covered in more detail below.

We Made Appropriate Inquiries and Followed Them Up During Our 1979 Hutton Group Audit

Prior to 1979, Hutton had used drafts as its primary method of paying customers and vendors. During 1979, Hutton changed from using drafts to checks for substantially all disbursements. Under generally accepted accounting principles, issued and uncleared drafts are normally reflected as liabilities. Checks that are issued and outstanding are deducted from the related cash balance on the books. To the extent a book cash balance becomes negative, a liability is reported.

We paid particular attention in our 1979 audit to Hutton's change from issuing drafts to issuing primarily checks. Because of the distinction between a draft and a check, we concluded that the company's prior caption, "Drafts Payable," would not adequately describe the company's situation at year-end 1979. Further, we noted apparent similarities between Hutton's cash management procedures and those of the TI Corp., as described in press reports of a 1976 case involving the overdrawing of bank accounts. Accordingly, we initiated the following specific actions:

- In late February 1980, after preliminary discussions with the Hutton Group's assistant controller, we met with Mr. Thomas P. Lynch, the Hutton Group's Chief Financial Officer, who was a member of the Board of Directors and the Executive Committee. Mr. Lynch was our primary contact for audit matters. We expressed our belief that the financial statement caption "Drafts Payable" needed to be expanded to properly describe checks issued and outstanding at year-end in excess of the related book cash balances. Mr. Lynch agreed to change the balance sheet caption to "Drafts and Checks Payable" to properly disclose Hutton's practice.

- At the same meeting with Mr. Lynch, we gave him copies of The Wall Street Journal clippings dealing with the 1976 indictment and "no contest" plea by TI Corp., and we raised our questions about the propriety of the company's cash management procedures. At our urging, Mr. Lynch called Mr. Loren Schecter, Vice President and Assistant General Counsel, to discuss the legality of Hutton's cash management procedures. Our internal memorandum of this meeting has been provided to the Subcommittee.

- Shortly thereafter, we discussed the propriety of the company's cash management procedures with Mr. Thomas W. Rae, Executive Vice President and General Counsel, and provided him with copies of the clippings dealing with TI Corp. He agreed to arrange another meeting at which

Mr. William Sullivan, the Vice President who was in charge of money mobilization, would make a full presentation on Hutton's practices and Mr. Rae would resolve the legal issue.

- The follow-up meeting was held about a week later, on March 5, 1980, with Mr. Sullivan and Mr. Rae. Also in attendance from Hutton Group were Mr. Michael Castellano, Controller, and Mr. Lawrence Volpe, Assistant Controller. Representatives of our firm attending the meeting were Mr. Joel Miller, the audit engagement partner; Mr. Louis Lynn and Mr. John Tesoro, audit managers; and Mr. Pat Gallagher and Mr. Ted Chambers, audit seniors. Our internal memorandum of this meeting has also been provided to the Subcommittee.

The objectives of the March 5 meeting, which lasted nearly three hours, were to obtain a greater understanding of Hutton's cash management procedures and to resolve the legal issue we had raised. In particular, we wished to understand better the procedure of writing checks against certain individual bank accounts even though the balance in those accounts, per Hutton's books, was zero or sometimes even negative.

At the meeting, Mr. Sullivan described the company's cash management system. Mr. Rae then explained that the major factor that permitted Hutton to legally engage in such transactions was that the company had the "means" to make ultimate payment. Mr. Rae concluded that the fact that Hutton had the means to pay precluded any possible illegalities. Mr. Sullivan further pointed out that the company was "above board" in its dealings with the banks, and that the banks were fully aware of these transactions.

At the end of this March 5 meeting, we asked Mr. Rae to put his opinion in writing to document that Hutton's activities in this area did not present any potential legal problems. While Mr. Rae declined to render a written opinion, he repeated that the banks were fully cognizant of Hutton's procedures, that what Hutton did was an accepted banking practice, and that there was no question about its propriety.

We did not insist upon a separate written legal opinion from Mr. Rae because, based on our dealings with him over many years, we had confidence in his professional ability and integrity. Moreover, his oral opinion and his analysis in support of that opinion were rendered at the end of a lengthy meeting that had been organized specifically to resolve our questions about the cash management system — a meeting also attended by other Hutton Group executives. After our discussions with Mr. Rae, we reported to Mr. Lynch the salient points of the March 5 meeting, including Mr. Rae's opinion that the Hutton system was legal.

Furthermore, we received a management representation letter in connection with our 1979 audit, which specifically indicated that, among other things, "[t]here are no violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency . . . ." That letter was signed by senior executives and financial officers of the Hutton Group.

We believe our prompt follow-up with the Hutton Group's senior management, including the General Counsel, was fully in accordance with professional auditing standards dealing with possible illegal acts. Those standards indicate that, while auditors must be aware of the possibility of illegal acts that may have a material effect on the financial statements, "[a]n examination made in accordance with generally accepted auditing standards cannot be expected to provide assurance that illegal acts will be detected."(1)

On the other hand, if a potential illegality comes to the auditor's attention in the course of his work, the standards require him or her to "inquire of the client's management and consult with the client's legal counsel or other specialists, as necessary, to obtain an understanding of the nature of the acts and their possible effects on the financial statements."(2) Not only did we follow this standard, but it was our alertness to the situation of a totally unrelated company, TI Corp., that raised a question about Hutton's cash management practices in the first place.

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1) Codification of Statements on Auditing Standards (New York: American Institute of Certified Public Accountants, 1984), AU Section 328.03, p. 129.

2) Codification of Statements on Auditing Standards (New York: American Institute of Certified Public Accountants, 1984), AU Section 328.04, p. 130.

The Disclosure of Drafts and Checks Payable as a Liability on the Balance Sheet Should Have Alerted Readers to Hutton's Use of Float

There has been some recent discussion about Hutton Group's use of the balance sheet caption "Drafts and Checks Payable." We believed at the time of our 1979 audit, as we do today, that the use of that caption on the face of the balance sheet prominently and accurately described the extent of the company's book overdraft position consisting of (1) checks issued and outstanding at year-end in excess of the related book cash balances and (2) uncleared drafts.

The disclosure of drafts and checks payable on the face of the Hutton Group's balance sheet (particularly when compared to unrestricted cash balances) should have alerted users of its financial statements, including regulatory agencies, to the full extent of Hutton's book overdrafting. Not only was such disclosure made in the consolidated financial statements of the Hutton Group, but it also appeared in the separate financial statements which the broker-dealer subsidiary, Hutton, filed with the Securities and Exchange Commission on Form X-17A-5. Such disclosure clearly indicates that Hutton was using a noninterest-bearing source of funds (drafts and checks payable) to finance its business, much in the same way that accounts payable to suppliers represents a similar source of noninterest-bearing financing.

The Classification of Drafts and Checks Payable as Liabilities on the Balance Sheet Was Proper and in Accordance with Generally Accepted Accounting Principles

Accounting Literature

The classification of a book overdraft as a liability is well-established in the accounting literature. In fact, this subject has been addressed consistently for decades in numerous accounting textbooks. As an example, consider the following quotation from Intermediate Accounting by Karrenbrock and Simons, published over 30 years ago:

> "A credit balance in the cash account resulting from the issuance of checks in excess of the amount deposited and available for payment of such checks is known as a cash overdraft and should be reported as a current liability. The existence of an overdraft may not necessarily occasion any embarrassment to the company if a number of checks are outstanding and deposits are made before checks are actually cleared. When a company has several balances with a single bank, an overdraft may be offset against a positive bank balance for balance sheet purposes. Opinion is divided as to the procedure that should be followed when there is an overdraft in one bank along with a positive balance in another. Some suggest that offset is proper in view of the possibility of clearing the overdraft by the transfer of funds from the positive balance to the account that is overdrawn. A stronger case, however, can be made for the recognition of both an asset and a liability balance: the business has a claim against one party and an obligation to another."(3)

More recent accounting literature adopts the same approach. For example, the 1974 edition of Finney and Miller's Principles of Accounting, Intermediate states:

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3) Wilbert E. Karrenbrock and Harry Simons, Intermediate Accounting, 2nd ed. (Cincinnati: South-Western Publishing Company, 1953), p. 159.

> "A bank overdraft exists when a depositor issues checks in excess of the amount he has on deposit in his bank account. Under these circumstances, the account is said to be overdrawn. There is some difference of opinion among accountants as to the proper balance-sheet treatment of overdrafts.
>
> If there is only one bank account and this account is overdrawn, the amount of the overdraft must be shown as a liability.
>
> If there are several bank accounts, one or more with overdrafts and one or more with available balances, and if the available balances are in excess of the overdrafts, it has until recently been regarded as permissible to show on the asset side of the balance sheet the excess of the available bank balances over the overdrafts, particularly if it is the company's practice to transfer funds from bank to bank as required. However, this opinion is no longer generally held, and it is now considered better practice to show the bank balances on the asset side and the overdrafts on the liability side. Some accountants still consider it permissible merely to show on the asset side the net available bank funds, provided that reference is made to the overdrafts by the use of some clearly descriptive balance-sheet title, such as 'Cash in Banks-Net of Overdrafts.'
>
> Some accountants have taken the position that if the company's books show an overdraft, whereas the bank statement shows an available balance (the difference being represented by outstanding checks), such an overdraft may be offset against balances in other banks without disclosure in the balance sheet, disclosure being necessary only if the bank statement shows an overdraft. Such a distinction scarcely seems logical. If the checks are outstanding, the issuing company has no control over them and, so far as available funds are concerned, an overdraft in fact exists."(4)

Similarly, Intermediate Accounting by Danos and Imhoff, published in 1983, indicates:

> "It is generally acceptable to offset an overdraft or a credit cash balance in one account with a positive cash balance in another account if both accounts are with the same financial institution. However, such offsetting is not acceptable if the accounts are with different banks. When different banks are involved or when there is only one account, the credit balances, or overdrafts, should be reported as current liabilities."(5)

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4) Glenn L. Johnson and James A. Gentry, Jr., Finney and Miller's Principles of Accounting, Intermediate, 7th ed. (Englewood Cliffs N.J.: Prentice-Hall, Inc., 1974), p. 225.

5) Paul Danos and Eugene A. Imhoff, Jr., Intermediate Accounting (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1983), p. 231.

Consistent with the preceding literature, the Hutton Group adopted the most conservative practice of determining book overdrafts on an account-by-account basis.

Current Accounting Practice

A recent computerized search of the financial statements of almost 4,000 SEC-registered companies (using the National Automated Accounting Research System 1983-84 database) revealed that 47 companies, including 27 companies whose securities are listed on the New York Stock Exchange, used the terms "Checks Payable," "Checks Outstanding," or "Outstanding Checks" to describe a book overdraft position. In a significant majority of those instances, the companies included the overdraft in "Accounts Payable" or another balance sheet caption without the same prominence given by Hutton Group to its overdraft position. In those instances, a reader of the financial statements would be able to identify the practice and amounts involved, but only through a detailed reading of the footnotes to the financial statements.

Attached as Exhibit A is a schedule that lists these companies, the accounting firm for each, the exchange on which their stock is traded, and whether the book overdraft was reflected in a separate caption on the face of the balance sheet or as part of another account caption. Exhibit A shows that many large companies reported book overdrafts as liabilities in financial statements reported upon by a variety of well-known accounting firms. Excerpts from these financial statements have been provided to the Subcommittee.

The practice of using captions such as "Drafts Payable" or "Drafts and Checks Payable" to describe a book overdraft position is particularly prevalent in the brokerage industry. A review of recent audited financial statements (Form X-17A-5) of 47 of the 50 largest broker dealers (in terms of capital) on file with the SEC revealed that close to 40% use such captions on the face of their balance sheets: specifically, 11 use "Drafts Payable," three use "Drafts and Checks Payable," one uses "Checks and Drafts Payable" and three use other similar captions.

In almost every one of the 18 cases, the amount of the book overdraft is considerably in excess of the unrestricted cash balance shown in the financial statements. A list of these companies is attached in Exhibit B; excerpts from the SEC filings of these companies have been provided to the Subcommittee. Indeed, the practice of both including a "Drafts Payable" caption and having it exceed "Cash" is apparently so commonly accepted that the attached model balance sheet from the 1985 AICPA guide entitled "Audits of Brokers and Dealers in Securities" (Exhibit C) shows "Drafts Payable" exceeding "Cash" by a significant degree.

Consultation within Arthur Andersen & Co.

Before arriving at our final view of the accounting and disclosure to be followed by the Hutton Group in 1979, Mr. Miller consulted with the partner in charge of our New York banking and financial audit division and with our firm's regional accounting and audit practice director. This was in accordance with our practice of internal crosschecking on technical issues to ensure that decisions we reach are those of the firm, not just the engagement team. Furthermore, the matter of overdrafting and the related accounting and disclosure issues were considered by a partner not involved in the Hutton Group audit, as part of an independent reading of the financial statements prior to their release. This "second partner review" is another element of our quality control procedures.

Our Audit Work in Years after 1979 Continued to Consider the Effects of Hutton's Overdrafting Practices

From 1979 through 1984, "Drafts and Checks Payable" decreased in importance in comparison to other items on the balance sheet. For example, while the amount of "Drafts and Checks Payable" of Hutton increased 52% between 1979 and 1984, total assets and liabilities other than subordinated debt each grew more than 350% during that period.

During the audits for each year, we continued to follow audit procedures in the cash area similar to those in prior years. In addition, as the various investigations evolved, our audit work was expanded further to consider the potential effect of these investigations on the Hutton Group's financial statements. Our focus was principally on the appropriate disclosure and the adequacy of the reserve for litigation. Among other things, we discussed the Grand Jury investigation with the General Counsel and the Chief Financial Officer.

In all years, the General Counsel provided us with a legal representation letter which indicated that the ultimate effect of all claims, lawsuits and contingent liabilities would not result in any material adverse effect on the financial condition of the company. He also stated that he was not aware of any "material contingent liabilities not presently involving claims or lawsuits that are probable of assertion and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome which would require disclosure under the applicable requirements of the Statement of Financial Accounting Standard No. 5."

Each year we also received a representation letter from the management of the Hutton Group which, among other things, advised us that they were not aware of any violations of law that should be considered for disclosure in the financial statements. Moreover, each year, we confirmed directly with numerous banks information concerning bank balances, outstanding loans to Hutton, lines of credit and compensating balance arrangements. Throughout the period, not a single bank, in responding to all of our confirmation requests, made any comments to us regarding the company's cash management procedures or the adequacy of its compensation; nor did any bank express concern about Hutton's overdrafting.

Conclusion

In summary, we believe that the accounting treatment and disclosure we recommended starting in 1979 was proper and in accordance with generally accepted accounting principles. The disclosure of "Drafts and Checks

Payable" as a separate liability caption on the face of the Hutton Group's balance sheet (particularly when compared to unrestricted cash balances) should have alerted readers to the full extent of Hutton's book overdrafting.

We would be pleased to answer any questions from Subcommittee members concerning these matters.

Exhibit A

COMPANIES REPORTING BOOK OVERDRAFT POSITIONS

Source: National Automated Accounting Research System (NAARS)

Company	Year of Annual Report	Auditors	Stock Exchange	Disclosure of Overdraft Contained -- In a Separate Balance Sheet Caption	Within Another Balance Sheet Caption, with Footnote Disclosure	Balance Sheet Caption Description
Genesco, Inc.	1983	Price Waterhouse	NYSE		X	Accounts Payable
Moza Energy Corporation	1983	McGladrey Hendrickson & Co.	OTC	X		Outstanding Checks in Excess of Bank Balance
Tyson Foods, Inc.	1983	Arthur Young	OTC		X	Trade Accounts Payable
Swift Independent Corp.	1983	Arthur Young	ASE		X	Accounts Payable
Dorchester Gas Corporation	1983	Deloitte Haskins & Sells	ASE		X	Accounts Payable
Air Products & Chemicals, Inc.	1983	Arthur Andersen	NYSE		X	Trade and Other Payables
Outboard Marine Corp.	1983	Arthur Andersen	NYSE		X	Trade Accounts Payable
Esmark, Inc.	1983	Arthur Young	NYSE		X	Accounts Payable
Mapco Industries, Inc.	1983	Alexander Grant	NYSE		X	Accounts Payable
Texas Eastern Corporation	1983	Peat Marwick Mitchell	NYSE		X	Accounts Payable -- Other
United Telecommunications, Inc.	1983	Arthur Young	NYSE	X		Outstanding Checks in Excess of Cash Balances
Eastern Airlines, Inc.	1983	Price Waterhouse	NYSE		X	Accounts Payable

COMPANIES REPORTING BOOK OVERDRAFT POSITIONS

Source: National Automated Accounting Research System (NAARS)

Company	Year of Annual Report	Auditors	Stock Exchange	Disclosure of Overdraft Contained — In a Separate Balance Sheet Caption	Disclosure of Overdraft Contained — Within Another Balance Sheet Caption, with Footnote Disclosure	Balance Sheet Caption Description
American Cyanamid Co.	1983	Peat Marwick Mitchell	NYSE		X	Accounts Payable and Accrued Expenses
W.W. Grainger, Inc.	1983	Alexander Grant	NYSE		X	Trade Accounts Payable
Pacific Gamble Robinson Co.	1983	Peat Marwick Mitchell	OTC	X		Outstanding Checks, Net
Nash-Finch Co.	1983	Peat Marwick Mitchell	OTC	X		Outstanding Checks, Net of Cash in Banks
Arkla, Inc.	1983	Touche Ross	NYSE		X	Accounts Payable
Legett & Platt, Inc.	1983	Alexander Grant	NYSE		X	Other Current Liabilities
Borg-Warner Corp.	1983	Peat Marwick Mitchell	NYSE		X	Accounts Payable and Accrued Expenses
The E. F. Hutton Group Inc.	1983	Arthur Andersen	NYSE	X		Drafts & Checks Payable
Pay 'n Save Corp.	1984	Price Waterhouse	OTC		X	Accounts Payable
Montana-Dakota Utilities Co.	1983	Arthur Young	NYSE		X	Accounts Payable
Germania Federal Savings and Loan Association	1983	Price Waterhouse	OTC	X		Official Checks Outstanding

COMPANIES REPORTING BOOK OVERDRAFT POSITIONS

Source: National Automated Accounting Research System (NAARS)

Company	Year of Annual Report	Auditors	Stock Exchange	Disclosure of Overdraft Contained — In a Separate Balance Sheet Caption	Disclosure of Overdraft Contained — Within Another Balance Sheet Caption, with Footnote Disclosure	Balance Sheet Caption Description
American Investors Life Insurance Co.	1983	Touche Ross	OTC	X		Excess of Outstanding Checks Over Bank Balance
Tech America Group, Inc.	1983	Touche Ross	ASE	X		Checks Outstanding in Excess of Bank Balance
Inter-Regional Financial Group, Inc.	1983	Touche Ross	NYSE		X	Short-term Borrowings -- Loans of the Securities Subsidiary
Weisfields, Inc.	1984	Laventhol & Horwath	OTC		X	Trade Accounts Payable
Pay Less Drug Stores Northwest, Inc.	1984	Peat Marwick Mitchell	NYSE		X	Accounts Payable
Pacific Telesis Group	1983	Coopers & Lybrand	NYSE	X		Cash Overdrafts
W. A. Krueger Co.	1983	Arthur Andersen	OTC	X		Excess of Outstanding Checks Over Cash Balances
A. G. Edwards, Inc.	1984	Touche Ross	NYSE	X		Drafts and Checks Payable
Midway Airlines	1983	Arthur Young	OTC		X	Accounts Payable
Super Valu Stores, Inc.	1984	Touche Ross	NYSE	X		Checks Outstanding, Net
Fedders Corp.	1983	Arthur Young	NYSE		X	Accounts Payable

COMPANIES REPORTING BOOK OVERDRAFT POSITIONS

Source: National Automated Accounting Research System (NAARS)

Company	Year of Annual Report	Auditors	Stock Exchange	Disclosure of Overdraft Contained —		Balance Sheet Caption Description
				In a Separate Balance Sheet Caption	Within Another Balance Sheet Caption, with Footnote Disclosure	
Foote, Cone & Belding Communications, Inc.	1983	Arthur Andersen	NYSE		X	Accounts Payable
Martin Marietta Corp.	1983	Ernst & Whinney	NYSE		X	Netted Against Cash and Short-term Investments
Del E. Webb Corp.	1983	Peat Marwick Mitchell	NYSE		X	Accrued Liabilities and Other Payables
Evans & Sutherland Computer Corp.	1982	Peat Marwick Mitchell	OTC	X		Outstanding Checks in Excess of Bank Balances
AT&T Technologies, Inc. (formerly Western Electric Co.)	1983	Arthur Young	NYSE	X		Drafts and Checks Payable Offset Against Cash Balance
Anthem Electronics	1984	Ernst & Whinney	ASE	X		Bank Checks Outstanding, Less Cash on Deposit
Distribuco Inc.	1984	Ernst & Whinney	OTC	X		Accounts Payable Including Bank Checks Outstanding, Less Cash on Deposit
Wetterau, Inc.	1984	Peat Marwick Mitchell	OTC	X		Checks Outstanding, Net of Deposits
SFN Companies, Inc.	1984	Arthur Andersen	NYSE		X	Accounts Payable
Biotech Research Laboratories, Inc.	1983	Coopers & Lybrand	OTC		X	Netted Against Cash Caption in the Balance Sheet

COMPANIES REPORTING BOOK OVERDRAFT POSITIONS

Source: National Automated Accounting Research System (NAARS)

Company	Year of Annual Report	Auditors	Stock Exchange	Disclosure of Overdraft Contained —		Balance Sheet Caption Description
				In a Seperate Balance Sheet Caption	Within Another Balance Sheet Caption, with Footnote Disclosure	
Bobbie Brooks, Inc.	1984	Peat Marwick Mitchell	NYSE		X	Accrued Expenses and Other Current Liabilities
Golden Enterprises, Inc.	1984	Dudley, Hopton-, Jones, Sims & Freeman	OTC	X		Checks Outstanding in Excess of Bank Balances
Arrow Automotive Industries	1983	Ernst & Whinney	ASE	X		Cash Overdraft

Exhibit B

BROKER-DEALERS WITHIN THE TOP 50
REPORTING BOOK OVERDRAFTS

Source: SEC X-17A-5 Reports

Company	Date of Financial Statements	Unrestricted Cash	Book Overdraft	
			Liability	Balance Sheet Description
		(Amount in Millions of Dollars)		
Merrill Lynch, Pierce, Fenner & Smith Incorporated and Subsidiaries	12/28/84	$118	$163	Other Liabilities - Drafts
Dean Witter Reynolds Inc.	12/31/84	$ 79	$596	Drafts Payable
E. F. Hutton & Company Inc. and Subsidiaries	12/31/84	$ 36	$405	Drafts & Checks Payable
Prudential-Bache Securities Inc. and Subsidiaries	12/31/84	$181	$277	Drafts Payable
Bear, Stearns & Co. and Subsidiaries	4/30/84	$ 13	$ 74	Drafts Payable
Drexel Burnham Lambert Incorporated and Subsidiaries	12/31/84	$103	$164	Drafts Payable
Kidder, Peabody & Co. Incorporated	11/30/84	$ 7	$133	Drafts Payable
Smith Barney, Harris Upham & Co. Incorporated and Subsidiaries	3/30/84	$ 9	$ 52	Drafts & Checks Payable
A. G. Edwards & Sons, Inc.	2/28/85	$ 12	$ 57	Drafts & Checks Payable
Oppenheimer & Co., Inc. and Subsidiaries	4/30/84	$ 6	$ 24	Drafts Payable

BROKER-DEALERS WITHIN THE TOP 50
REPORTING BOOK OVERDRAFTS

Source: SEC X-17A-5 Reports

Company	Date of Financial Statements	Unrestricted Cash	Book Overdraft	
			Liability	Balance Sheet Description
		(Amount in Millions of Dollars)		
Alex. Brown & Sons, Inc.	9/28/84	$ 5	$ 5	Cash Management Facility
Bateman Eichler, Hill, Richards Incorporated	12/31/84	$ 2	$ 2	Bank Overdraft
Prescott, Ball & Turben, Inc.	12/31/84	$ 8	$ 23	Drafts Payable
Advest, Inc.	9/30/84	$ 3	$ 4	Drafts Payable
Securities Settlement Corporation	12/31/84	$ 25	$ 25	Drafts Payable
Piper, Jaffray and Hopwood Incorporated	9/28/84	$ 13	$ 17	Checks and Drafts Payable
Fidelity Brokerage Services, Inc.	12/31/84	$ 3	$ 15	Drafts Payable
Dain Bosworth Incorporated	12/31/84	$ 15	$ 8	Drafts Payable

Exhibit C

STANDARD STOCKBROKERAGE CO., INC.
AND SUBSIDIARIES
Consolidated Statement of Financial Condition
December 31, 19X1

ASSETS

Cash	$ 2,647,472
Cash and securities segregated under federal and other regulations (Note 3)	1,005,000
Deposits with clearing organizations and others (Cash $345,000 and securities with a market value of $1,400,000)	1,745,000
Receivable from brokers and dealers	25,476,250
Receivable from customers (Note 4)[1]	40,360,723
Securities purchased under agreements to resell	6,282,498
Securities owned (Note 5)	
Marketable, at market value	20,736,387
Not readily marketable, at estimated fair value	10,730,685
Spot commodities owned, at market value	3,278,000
Secured demand notes collateralized by marketable securities	5,215,000
Memberships in exchanges	
Owned, at cost less $825,000 valuation allowance (market value $2,000,000)	2,100,000
Contributed for the use of the Company, at market value	375,000
Furniture, equipment, and leasehold improvements, at cost, less accumulated depreciation and amortization of $2,425,249 (Note 9)	4,581,709
Other assets	723,459
	$125,559,243

The accompanying notes are an integral part of these financial statements.

LIABILITIES AND STOCKHOLDERS' EQUITY

Short-term bank loans (Note 6)	$ 23,000,000
Drafts payable	3,902,000
Payable to brokers and dealers	12,015,622
Payable to clearing broker (Note 7)	9,359,621
Payable to customers (Note 4)	12,298,629
Securities sold under agreements to repurchase (Note 8)	5,780,498
Securities sold, but not yet purchased, at market value (Note 5)	1,862,729
Income taxes, including deferred taxes of $1,200,000	2,276,473
Accounts payable, accrued expenses, and other liabilities	2,449,499
Long-term notes payable (Note 9)	3,000,000
	75,935,071
Commitments and contingent liabilities (Note 13)	
Liabilities subordinated to claims of general creditors (Note 10)	9,897,000
Stockholders' equity (Notes 11 and 14)[2]	
Preferred stock	5,000,000
Common stock	6,289,000
Additional paid-in capital	2,200,000
Retained earnings	27,438,172
Less common stock in treasury, at cost	(1,200,000)
Total stockholders' equity[3]	39,727,172
	$125,559,243

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[1] Valuation reserves should be shown parenthetically or in a note if material.

[2] As discussed in the "Statement of Financial Condition" section of chapter 2, it is permissible to present a combination of subordinated liabilities and stockholders' equity. An acceptable presentation is illustrated on the following page.

Subordinated liabilities and stockholders' equity		
Liabilities subordinated to claims of general creditors (Note 10)		9,897,000
Stockholders' equity (Notes 11 and 14)		
Preferred stock	$5,000,000	
Common stock	6,289,000	
Additional paid-in capital	2,200,000	
Retained earnings	27,438,172	
Less common stock in treasury at cost	(1,200,000)	
Total stockholders' equity		39,727,172
Total subordinated liabilities and stockholders' equity		49,624,172

[3] It is permissible, for the purpose of the separate report on the statement of financial condition (which is required to be distributed to customers) to present only the total of stockholders' equity without disclosure of the various components.

Source: American Institute of Certified Public Accountants; Audit and Accounting Guide, Audits of Brokers and Dea'^rs in Securities Revised Edition

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Mr. Mazzoli. Thank you. Well, by agreement we will very soon rise and come back at 2 o'clock, then, for the question part.

Mr. Peller. Mr. Mazzoli, if I might, there's one point that was covered this morning by Mr. Briloff that perhaps might be helpful to clarify, the question of bank overdrafts, book overdrafts. This is something that got bandied about.

A week ago, when we met with the staff, we went through an illustration that was, I thought, helpful to them, and I was wondering whether it might be helpful to the committee for us to——

Mr. Mazzoli. If it's not too esoteric, certainly.

Mr. Peller. We've tried to keep it——

Mr. Mazzoli. Try to make it simple, if I can understand it.

Mr. Peller [continuing]. Very straightforward.

Mr. Mazzoli. Yes.

Mr. Shaw. Mr. Chairman——

Mr. Mazzoli. Certainly.

Mr. Shaw [continuing]. Would he prefer for the other members to be back, or is it something that would be fine for the two of us to look at?

Mr. Mazzoli. Well, you know that's an interesting point, because if it's useful, maybe the whole panel could——

Mr. Peller. Perhaps when we reconvene we can——

Mr. Mazzoli. Why don't we do this then, in line with what the chairman had talked with us, let's adjourn now and we'll come back at 2 o'clock, and we'll hear from you, first of all, and perhaps you can explain this point, and then we'll get into the questions. Thank you.

We stand in recess.

[Whereupon, at 12:30 p.m., the subcommittee was recessed, to reconvene at 2 p.m., the same day.]

AFTERNOON SESSION

Mr. Hughes. The Subcommittee on Crime will come to order.

You had said you wanted to explain a chart that had some additional testimony you wanted to present before we get into questions, and you may proceed.

Mr. Peller. Thank you, Mr. Chairman. Right before lunch, before the subcommittee adjourned, we had suggested this would be a good way to perhaps, one, clear up some misconceptions and also illustrate the fundamental accounting for book overdrafts in the financial statements. It's something we had used with the staff last week in our discussion.

What this chart illustrates for a company is, a company that has three bank accounts in each of three different banks. And the topline on that chart, that's marked "Balance Per Bank," represents the cash as reflected on the books of the bank. It's the amount that would appear on a bank statement, it's the amount that's confirmed to us by banks during our normal confirmation process.

The point that should be made here is that, in this particular case, we ultimately wind up with some book overdrafts, but from the standpoint of balance per bank, the cash balance per bank, at least in the case of bank A and bank B, those amounts are positive amounts. There is no overdraft, there is not a bank overdraft.

The next line on the chart represents deductions for checks that have been written by the company and mailed to customers or vendors. From a book standpoint, those amounts are deducted from the book balances to arrive at a balance per books. In the case of this illustration, bank A shows a positive cash balance of $200. Banks B and C show book overdrafts of $20 and $300.

If you think about our own checking accounts, at the end of a month the item that's marked "checks issued and outstanding" represents the outstanding check element in reconciling from the balance reflected in the bank statement to your own checkbook balance.

The question, then, is how are all of these reflected in the books of the company? There was some testimony this morning about whether it's appropriate to net these amounts down, for example, to show zero cash and $120 book overdraft, which is the total in the far right-hand column. As set forth in our written testimony, we believe that the bulk of the professional literature suggests that this comparison, in looking at positive and negative cash balances, be done on a bank-by-bank basis. So that, in this particular case, the financial statements would show $200 of cash, which is basically the cash that sits in bank A, and $320 of checks payable, the sum of the book overdrafts in accounts B and C. That's essentially what we think the accounting literature recommends as the preferable approach. This is essentially what was done in the preparation of the financial statements of E.F. Hutton.

One last comment. The notion of netting these things down in fact, as Mr. Briloff suggested this morning, is one of the few things, I guess, that we agreed upon, but the notion of netting these things down is an accepted practice, but certainly not what the literature suggests is the preferred practice. The idea of showing a much larger overdraft is typically thought to be a fairer presentation of a company's financial position.

And again, the last point is that, after going through all of this, the banks—there are no bank overdrafts. No amounts to pay interest on, and this is what we think the financial statements reflect so clearly.

Mr. HUGHES. Well I appreciate that graphic explanation, and even though I think that what you've just described is a simple way of describing what can happen to any company or individual, for that matter, where they have several bank accounts where checks are outstanding. I understand that any given period, if you take a photograph of it that it could show quite a difference between what really is in the bank and what is on your ledgers, I understand that.

But as I understand the practice that we're talking about, it's when you have a bank account with $300 in it, another bank account with $100 in it, then you draw a third check for $1,000—and that's a practice with which we have some concern.

Mr. PELLER. Yes, I understand.

Mr. HUGHES. There is no relationship whatsoever—and I'm not sure as to what period of time, because we haven't really pinned that down—there is no relationship between the drawdown sheets that were developed by E.F. Hutton and the amount that was actually being drawn down. The drawdown sheets were discarded at some point. They became irrelevant. You'd see a deposit of $70,000 and a check issued for $7 million. No relationship between the two. No relationship between what was being drawn down and what really the liquid assets of the company were at any given time.

And that is the practice that we're concerned about and the crucial issue—and let me just see if I can frame it for you—is that the hierarchy of the company suggests that they didn't know what was going on. Now you've followed the testimony pretty carefully, and it has been an exercise in disclaimer and deniability. So on the one hand, they suggest that, because they had no internal audits, because they had no internal controls, that they weren't aware of the aggressive overdrafting. In fact, it's difficult at this point to find out just who had any knowledge, criminal knowledge of what was going on.

And so the suggestion has been made that one of the reasons why those in the boardroom, those in top management didn't know, is because it wasn't brought to their attention.

On the other hand, we have your testimony, and we have the memorandum which speaks for itself, which suggests that as early as March 1980, you were aware that there could be potentially some problems. And I think, to your credit, you brought it to their attention.

Now my question is, at this posture, obviously both can't be right. Would you agree with that? I mean, both positions can't be right. Either the company was aware of it and they considered it to be legal, or else in fact it wasn't brought to their attention by yourselves as their independent auditors, because they're just inconsistent. Would you agree?

Mr. **Peller**. I think the record, the memorandum that you have, indicates that we, in fact, did bring this——

Mr. **Hughes**. I happen to believe that you did bring it to their attention. Where I might fault you—and I invite you to respond—is whether or not you followed up on it, because I think the points that were made earlier are telling ones.

I think that, in the final analysis, Professor Briloff, I don't agree with all of his conclusions. I think that much of what he advanced presents a valid point of view and a case for the fact that it called for something more than just taking Mr. Rae's verbal opinion that it was legal, it was proper. It was above-board, he used the term.

In fact, the banks are encouraging us to do more. Chase Manhattan says we ought to do more. The fact of the matter is the banks were not aware of what was happening. When they did find out, they made claims for $200,000, $300,000. When your folks went in to audit the branch banks, when you went in to the Washington area, you picked up on some entries where there was a deposit of $70,000 and a drawdown of $7 million. Now——

Mr. **Peller**. I do not recall that our work reflected that——

Mr. **Hughes**. Well, we have some of your worksheets where that was actually picked up by one of your auditors.

Now, if we were talking about overdrafting of $1 million, of $2 million, of $5 million, maybe it wouldn't put you on notice. But when you have overdrafting that could reach perhaps $200 million—I mean in 1983, I believe it was, the checks, the drafts and checks payable amounted to over $400 million. We estimate as much as perhaps $200 million represented the aggressive overdrafting by the branch banks. And we feel that that's rather conservative. Surely that has to put you on notice when you go in and you audit a branch, because you did that—you went in, your auditors went into a branch and you picked out certain daily entries. You saw what a deposit was and what was being drawn down. Now surely that should put you on notice.

Mr. **Peller**. Mr. Chairman, to my knowledge, we did not visit that branch. I could be mistaken.

Mr. **Hughes**. Documents that suggest that your work papers contain evidence, at the very least, of irregular activities in the following accounts with Hutton's cash management system. Let me just indicate what they are. And I'm looking at the cash worksheet as of December 31, 1981.

[The document referred to follows:]

E F Hutton Co + Inc

Summary of Cash

Audit 12 31 81

General Ledger #	Name of Bank	X-Ref	Balance per BANK.	Less Outstanding Checks
99C03-1100	FIRST GREENWOOD BANK		28 00	
99C05-1100	BANKERS TRUST CO. OF DES MOINES		842 488 00	1 083 800 00
99C10-1100	FIRST NATIONAL BANK W ST LOUIS		2 524 25	
99C10-1101	BOATSMAN NATIONAL BANK OF ST LOUIS	T16/1 ⑰	<75 149 39>	<1 584 435 99>
99C12-1130	MERCANTILE BK OF ST CHARLES CTY		317 343 16	200 000 00
99C14-1100	NATIONAL BANK OF COMMERCE TRUST AND SAVINGS BANK		7 993 55	12 000 00
99C14-1101	FIRST NATIONAL BANK		<4 69>	
99C15-1101	CONTINENTAL BANK + TR CO.		14 947 33	1 014 900 00
99C15-1102	BRENTWOOD BANK	T16/1 ⑲	36 849 44	2 036 800 00
99C16-1100	RIGGS NATL BANK		2 536 416 57	2 536 400 00
99C16-1101	THE NATIONAL BANK OF WASHINGTON		50 071 20	50 000 00
99C16-1102	FIRST AMERICAN BK NA WASHINGTON		2 077 044 54	2 077 000 00
99C16-1103				
99C17-1100	MARYLAND NATIONAL BANK		128 529 13	138 000 00
99C18-1101	RIGGS NATL BANK		45 169 68	5 045 000 00
99C18-1102	FIRST AMERICAN BANK	T16/1 ⑳	2 500 722 82	11 500 772 00
99C20-1100	UNITED VA BANK	T16/1 ㉑	3 500 [illegible]	9 749 100 00
99C22-1100	THE FIRST NATIONAL BK	T16/1 ②	33 266 90	33 712 00
99C22-1102	COMMERCE BANK OF KANSAS CITY	T16/1 ③	23 384 976 13	23 395 000 00
99C22-1103	UNITED MISSOURI BK OF KANSAS CITY	T16/1 ④	6 789 64	30 600 00
99C22-1104	HOXIE STATE BANK		600 00	600 00
99C22-1114	TRADERS NATIONAL BANK		2 846 85	2 846 85
99C22-1123	FIRST NATL BANK OF TOPEKA		5 000 00	
99C23-1101	FIDELITY AMERICAN BANK		10 000 00	

Deposit in Transit	Bank Charges		Other Deductions	Other Additions		Balance per Books
			25.00			-0- ✓
						2524.25
		T17	1039200.00	4812.50		
		T17	900,000.00 ✓	600,000.00 ✓		
				12.50		
				10.00		
						16.57
						71.20
				10.00		54.54
				440.00		
	102.12					
						-0- ✓
						-0- ✓
						5000.00 ✓
						10000.00 ✓
						17666.56

Balance per Books	
241311 60	✓
2693972 88	✓
182654 84	✓
4006 45	✓
4 60	✓
999940 17	✓
1999940 56	✓
50	✓
9470 97	✓
4999830 32	✓
9000049 18	✓
9745599 21	✓
5 10	✓
10023 37	✓
23705 24	✓
29713518 38	✓

Mr. **Hughes**. Riggs National Bank, with a bank balance of $45,170; outstanding checks of $5 million.

First American Bank, with a bank balance of $2.5 million; outstanding checks of $11 million.

United Virginia Bank, that's the one I'm referring to in the Washington area, with a bank balance of $3,500; outstanding checks of $9.7 million.

You mean to tell me that that doesn't put you on notice?

Mr. **Peller**. I think, Mr. Chairman, in terms of going back, in fact, in time, the fact that we saw significant book overdrafts as early as the year 1979, in fact, did alert us to the question that there might be something wrong. And that was the very reason——

Mr. **Hughes**. That wasn't my question, though. I asked you a specific question.

Doesn't that—shouldn't that put you on notice? That in itself, shouldn't it put you on notice that something is wrong?

Mr. **Peller**. This was something that was, from our perspective, something that was part of a fundamental system that was——

Mr. **Hughes**. Don't you understand my question?

Mr. **Peller**. Yes, sir, I do. I believe I do.

Mr. **Hughes**. Well, the question is, shouldn't that put a seasoned veteran auditor on notice? And you have a fine reputation.

Mr. **Peller**. These are the amounts as reflected on the—going back to the schedule that we discussed earlier, this is essentially the balance on a book basis. These would not be bank overdrafts in the sense of the company's accounts being overdrawn at the bank. From the audit process, from the accounting process, the numbers that banks provide us, for example, as part of our confirmation process, represents the book process. Very few of the company's accounts, in this entire period of time, represented bank overdrafts. I think the numbers that I recall were something like 2 percent in dollars of bank overdrafts on a bank basis. These represent what we would call "book overdrafts."

Mr. **Hughes**. But the book overdrafts point—it seems to me it should send all kinds of alarms off when you have that kind of activity. And obviously, your auditors to be aware of the fact that this wasn't just an isolated practice. There were as many as 113 branches that had a checkbook to write on a special account, the zero balance account, to cover the overdrafts on a daily basis. And in that zero balance account there was as much as $1 billion in activity to cover overdrafting.

Now, surely in your audits you looked at the zero balance account and you saw all that activity.

Mr. **Peller**. Mr. Hughes, in terms of a time sequence, we raised the problem initially with the management and counsel of 1980. In 1982, we were called to a meeting where the chief financial officer of the company's general counsel, associate general counsel, and outside counsel basically told us about the fact that some checks had bounced in upper New York State, in the Genesee Country Bank. At the conclusion of that meeting—and this is a memorandum that was furnished to your staff, I believe it was either earlier this week or late last week—the bottom line of that meeting was that Messrs. Lynch, Rae, Shechter, and Sneiderman were of the opinion that there were no claims, asserted or unasserted, that Hutton would suffer no financial loss, and that the only exposure might be unfavorable publicity. So, that was a second step, in terms of going back and reacting to what Dr. Briloff commented on this morning, over the years that was a second step in terms of the followup process.

We mentioned in our written statement that we, over the 5- or 6-year period had, in fact, sent bank confirmations, confirmations of outstanding debt, confirmations of lines of credit and compensation——

Mr. HUGHES. But, Mr. Peller, that wouldn't really disclose much, because the bank's were duped. The banks, on a daily basis, were receiving additional bad checks to cover the checks that had been overdrawn, and so, as a result, every day on the banks ledgers it showed that they were in balance. So, what would that have disclosed?

You know, it's interesting. I hear the argument all the time that the banks have not really come forward, that many of them have not made claims, and that's an indication that the banks really weren't damaged. Well, the fact of the matter is that many of the banks are still having a hard time figuring out just what went on, because you're talking about literally tens of thousands of transactions, as you well know.

Mr. PELLER. Yes, sir.

Mr. HUGHES. And these banks were not privy to this scheme. And that's rather obvious because as early as 1981, when the banks found out about the scheme, they demanded restitution, and they were given restitution almost right away, when they caught up with the scheme.

So, those statements to the banks wouldn't be helpful, would they?

Mr. PELLER. Well, a number of the banks, in fact, we understand, subsequently, not from contemporaneous knowledge but subsequently, in fact did complain, and none of those banks that complained indicated—and certainly they had the opportunity—if they had a problem with the way they were being compensated, they could well have indicated that.

Mr. HUGHES. Well, they didn't have a problem, because when E.F. Hutton found out that somebody knew about it, they paid them off to keep them happy. And the fact of the matter is that every day E.F. Hutton made sure, through their operations—the regional office checked every day with the branch offices and the branch offices made sure that every day there was enough money in there to cover. They had a checkbook on the zero balance account, and if they were short by $2 million they wrote a check for $2 million and deposited it. So that bank would have no way of knowing when you sent that confirmation letter in.

Mr. PELLER. And that was one of the elements of the system as was described to us in early 1980 and was incorporated, I believe, in Mr. Miller's memorandum.

Mr. HUGHES. Yes, well, that's something else—Mr. Miller—and my time is up, and I have some other questions. We'll come back for another round.

Mr. Miller, what did you do after this meeting that took place on March 7, to check the accuracy of what was related to you? Because I get the feeling that you still were somewhat dubious.

Mr. MILLER. Well, after the meeting, sir, I reflected on the entire meeting; the fact that I had a hundred bank confirmations with no exceptions noted, and these are various types of confirmations; the fact that, in reviewing my work papers, I found no evidence of checks bouncing, I found no unusual fees being charged by the banks to Hutton; and, more importantly, I considered the nature of the opinion, the fact that I perceived it to be a serious opinion, I had given Mr. Rae the TI case a week before the meeting. At that time he couldn't answer my questions, he didn't have knowledge about the company's system. That meeting was arranged when Mr. Sullivan came. There were other professionals from Arthur Andersen there.

Mr. HUGHES. That's not my question. My question, however, is: What did you do after the meeting? Because, frankly, to your credit you did see that there were some problems. You also saw that there were some parallels with the TI decision which subsequently prompted you to bring to Hutton's management the potential problems in that area—to your credit.

But I read this memorandum—and you correct me if I am wrong—as one in which you still had some concerns. Because Sullivan—and I'm not going to quote it again—is trying to reassure you everything is above board—"Now, I'm not going to give you a written opinion, just take my word for it, everything is above board."

Mr. MILLER. But, sir, the meeting was not a meeting in a phone booth, it was a 3-hour meeting. Mr. Sullivan explained their procedures, he explained them on the blackboard. Mr. Rae listened, he opined on that very system. It's part of the record. I mean, to this day he says he gave us an opinion and there's some question of whether that is illegal even now, that very system. And that is what I relied on.

Mr. HUGHES. Did you ever get the bank's point of view on the system?

Mr. MILLER. No, sir.

Mr. HUGHES. Well, here's what you say: "Joel Miller——

You're Joel Miller, aren't you?

Mr. MILLER. Yes, sir.

Mr. HUGHES [continuing]. "Then stated that he would discuss the matter with other partners of Arthur Andersen & Co. whose clients include major money-center banks, to ascertain what the banks' point of view"—quote, unquote—"is regarding these transactions."

Mr. MILLER. Sir, I had a hundred confirmations from the bank. When I got back to my office and reflected on the entire meeting, I concluded that none of the banks had notified me of any problems——

Mr. HUGHES. So you didn't followthrough.

Mr. MILLER. Well, I followed through in that I reflected on the entire problem and I concluded I would stick by the opinion that I believe Mr. Rae gave me, and had full faith and confidence in a professional.

Mr. Hughes. You know, I really have—I understand and sympathize with the position you find yourself in, because you're in the hot seat now. Management at E.F. Hutton suggest that you were the culprits, essentially, that these practices weren't brought to their attention. They would have us believe that these widespread practices resulting in 2,000 counts of mail and wire fraud just spontaneously occurred, and that they weren't aware of it, that it just, lo and behold, it started in the branch offices. They were "off the reservation" at the branches and that they didn't know that they were making tens of millions of dollars in interest profit in this fashion. I'm not saying that I buy that, but they're suggesting that that's the case and that it was never brought to their attention.

They discount the storm warnings, the warnings that you brought to their attention. And what compounds it, unfortunately, as far as I am concerned, is the manner in which you did designate these entries.

Now, you can argue all you want that describing it as "drafts and checks payable" is adequate. I don't think the average investor would know what the practice is by reading that. Would you think he would?

If you had said "overdrafts," I think the average person would know. And it's interesting, in your statement in chief, when you're talking about broadening it from drafts to drafts and checks payable, you go on, then, to describe it as the overdrafting transactions. In other words, even in your own explanation you have to describe it as "overdrafting."

Mr. Peller. Mr. Chairman, the description of these items as "drafts and checks payable," as we indicated in our testimony, is, in fact, a commonly used term, "checks payable" is.

Mr. Hughes. Well, would you agree that if you had used the term "overdrafting," that people would know a lot more what you're talking about?

Mr. Peller. The concern that one might have, and very few companies, in fact, use that term, one of the problems that you have is that an overdraft simply connotes to many people a bank overdraft, the notion that the company is paying interest, if you will, on a bank overdraft. And we thought at the time, and, I think, still believe today, that the use of a term such as "checks payable" is more representative of the basic nature of the transaction. This was a noninterest bearing source of funds for the company, and to describe it as an overdraft, it seems to me, leads to some potential confusion on the part of a reader.

The other aspect of this is that many companies include these items in a caption called "accounts payable," and only when you go into a footnote do you find a fuller explanation of what that item is, that explanation being something like, "Accounts payable includes checks issued in excess of cash balances of blank dollars," and that's buried or disclosed in a footnote. We felt that disclosure on the face of the balance sheet was a very informed disclosure.

Mr. Hughes. Well, I can tell you that I'm not an accountant. I think I know how to read financial statements generally. I'm not sure that I would be put on notice as to what was taking place by reading "drafts and checks payable." If you had described it as "overdrafts" I would know. I know what an overdraft is. The average person knows what an overdraft is: When the bank calls and tells them their account's overdrawn, they know what that is. But I'm not sure, in the context—and we're talking about your responsibility is not just to the corporation, E.F. Hutton, but to the investing public, to the stockholders, the people that would read that financial statement and rely upon the financial condition of that business. And I'm saying to you, I don't think that you have fairly and honestly provided the information that would be needed for somebody reading that, to understand what was going on. And where I would fault you is that you knew what the practice was. You may not have known the extent of it, but you knew what the practice was.

And I would venture to say that very few of your corporate accounts run checks payable to the tune of $400 million at the end of a fiscal year. Would you disagree with that?

Mr. Peller. I think we have—in terms of our own clients, there are some that have significant overdrafts in relation to the size of their business. One would expect, in a financial services company, a brokerage firm to have a higher percentage. And I think the study that we've included in exhibit B in our written testimony in fact shows that the notion of reflecting drafts and checks payable or drafts payable of very significant amounts in fact appears in almost 40 percent of the 50 largest brokerage firms. So, in that sense, in the context of a brokerage firm, it's not that unusual. We made the point, again, in our written testimony, the "Broker-Dealer Audit Guide," which is the standard guidance to auditors, in fact uses as a model example a situation where a company has cash and has drafts payable of about 1½ times their cash balance, and that is the example that we used and attached as exhibit C to our written testimony.

Mr. Hughes. Are you familiar with any company that was engaged in aggressive overdrafting, generating such a high percentage of their net profits from just that activity during that period of time?

Mr. Peller. I can't respond in terms of generating net profits. I think the illustrating of the companies on this exhibit shows that many companies have very significant book overdrafts, in one instance of a larger amount and certainly, in other instances, of very significant amounts. And, so, in that sense the practice———

Mr. Hughes. So, your answer is that that, in itself, would not put you on notice, just that sum.

Mr. Peller. That's correct.

Mr. Hughes. That's your point. OK, thank you.

The gentleman from Florida, Mr. McCollum.

Mr. McCollum. Thank you very much, Mr. Chairman.

I'd like to followup on that. This morning Professor Briloff testified that whichever way the accounting entry went, whether it was "checks payable" or something else, what bothered him was the fact that it was no footnote, no broader explanation of this.

In retrospect now and hindsight, granted that it is—granted that it is—do you think that that would have been a prudent thing to do, to have explained it more elaborately?

Mr. Peller. If the company had felt it was an appropriate disclosure, I certainly would have had no problem. I think our experience suggests that most of the disclosure that we've used as illustrations here, the disclosures were about of the same level of information, in fact——

Mr. McCollum. Well, that may be the common thing in the industry, but don't you now think, in retrospect, looking at this thing, that that shouldn't be any longer the common practice in the industry, that you ought to have footnotes and insist on them as the accountant and auditor?

Mr. Peller. I think one of the problems, Congressman, is that when you start looking at every caption on the balance sheet, the question of—or of the income statement—the question from the auditor's perspective is, there are many important things and you try, or a financial accounting model tries, to set out what is important. Take receivables, for example, the fact that you have a receivable for 3 percent from one customer could well be an important fact if that customer goes bankrupt subsequently. And someone might say:

> Well, gee, it would have been a good idea to detail in the footnotes the composition of your accounts receivable so someone could make an evaluation of those receivables that were more important.

The objective of the financial statements is to make an evaluation overall of collectability and to set up an adequate reserve, but the information that is presented in the financial statements is normally presented in a relatively summarized way for users of financial statements. There's always a concern about burying so many facts so that the average user of financial statements can't discern what is important but accounted for.

Mr. McCollum. But if you've got the thing in a footnote fashion, you aren't burying anything, you're letting somebody who wants to look at it as the overview do that and somebody that wants to read the footnotes read them. I question that judgment call, and especially in terms of what we do in the future.

Mr. Miller, I want to get back to the questioning with regard to your meeting with Mr. Rae and the question of this issue over the illegality of the whole scheme. I have read your testimony on pages 5, 6, 7, 8, and so on—of Mr. Briloff's testimony—dealing with this meeting, dealing with the memo. And I've heard what you had to say. I gather that you've responded to Mr. Hughes that you did not go after you any bankers and ask them about the practice, you reflected on it.

Did you or anyone else in Arthur Andersen consult with an outside attorney, your own attorney or anyone else, about the legality of this matter after that March 1980 meeting?

Mr. Miller. I did not consult directly. However, in February 1982, we were called to a meeting and there was outside counsel of E.F. Hutton there, and it was Cahill Gordon. At that meeting there was a discussion of the occurrences when certain checks bounced in upstate New York.

Mr. McCollum. Could you speak into the microphone, please?

Mr. Miller. At that meeting there was a discussion of the occurrence of the events in upstate New York, where certain checks bounced. And we were given assurances that, in the opinion of these attorneys, there were no claims asserted or unasserted, that Hutton would suffer no financial loss.

Mr. McCOLLUM. You're saying this was in 1982?

Mr. MILLER. In February 1982.

Mr. McCOLLUM. This was about the time the Justice Department was getting into the act, or very close to that time, was it not?

Mr. MILLER. I believe it was before.

Mr. McCOLLUM. But you're saying that this counsel, whom you didn't personally see but somebody in the company did——

Mr. MILLER. No, I was at the meeting, sir.

Mr. McCOLLUM. You were at the meeting, too.

Mr. MILLER. Yes, sir.

Mr. McCOLLUM [continuing]. That this counsel said things to you that now, looking back on it, would mean that had he examined it in 1980, he would have said the same thing. In other words, you are saying that you had a certification in 1982 from an outside counsel that said what was going on in 1980, that you questioned Rae about, was, in fact, legal.

Mr. MILLER. Sir, we left that meeting with the feeling that the means principle—if you have the means to make payment on a check—still was binding. Nobody said anything at that meeting different than had been said at the prior meeting, and Mr. Rae was at that meeting as well.

Mr. McCOLLUM. Mr. Rae was at this meeting in 1982, as well.

Mr. MILLER. There were three attorneys at the meeting.

Mr. McCOLLUM. Whose outside counsel, yours or Hutton's?

Mr. MILLER. No, Hutton's.

Mr. McCOLLUM. All of the counsel that were at that meeting in 1982 were Hutton's counsel?

Mr. MILLER. Two of them were internal counsel and one of them was outside.

Mr. McCOLLUM. Doesn't it occur to you that as much as you might respect Mr. Rae and E.F. Hutton, that this whole idea of depending upon your client's counsel, whether that's inside or outside, for an opinion in an area like this, is like asking the fox to guard the chicken coop, and that you, as an independent, outside auditor, hired by a company in this situation, ought to be going to somebody you hire rather than somebody that the client hires?

Mr. MILLER. Sir, I felt confident in going to Mr. Rae. I had known him for many years. I knew of his background.

Mr. McCOLLUM. But isn't that like going to the fox guarding the chicken coop, Mr. Miller? Isn't that exactly the same thing?

You may have felt the confidence in him, but it seems to me that as a person who deals in auditing, you have to realize that you're dealing with somebody, when you deal with Mr. Rae, who is a part of the organization. He was a member of the board of directors, even, he had a vested interest, he had a natural bias. And as much as he may have given you good opinions in the past, you'd never, apparently, suspected anything being illegal before now.

Why wouldn't you have been willing to go outside on your own?

Mr. MILLER. First of all, after this meeting I still felt that what they were doing was legal. Your staff has this memo of February 25, 1982, where there was no indication for any concern, and——

Mr. **McCollum**. But you were concerned going into that meeting, or you wouldn't have raised the issue.

Mr. **Miller**. No, I didn't raise the issue. I was called to that meeting because I was signing off on the 1982 financial statements, and as part of full disclosure to us Mr. Tom Lynch called me and asked me if I could come to his office to a meeting. And I went with my manager, and I found three lawyers there, and they discussed what happened, and——

Mr. **McCollum**. In other words, you're telling me that nobody with your company, including yourself, prior to the time that Rae and Lynch raised the issue, ever thought that this money concentration scheme might be illegal, never had an idea that it might be illegal?

Mr. **Miller**. In 1980?

Mr. **McCollum**. 1980. March 1980.

Mr. **Miller**. I raised that issue, sir, in 1980.

This is now 1982. We went from 1980 to——

Mr. **McCollum**. OK, but I'm talking about 1980.

Mr. **Miller**. Yes, sir.

Mr. **McCollum**. I'm going back to 1980. I'm saying to you, after that 1980 meeting—not 1982, but 1980—doesn't it seem to you that at the time that you were asking counsel or relying on counsel's opinion, that it was inside counsel then, that they were, in fact, doing something legal, that you were, in fact, looking at somebody who was the fox guarding the chicken coop, in Mr. Rae, and even in 1982 you were still.

Mr. **Miller**. Sir, I believe I followed auditing literature. I had confidence in Mr. Rae. He had no responsibility for the cash management system, he was the firm's general counsel. He was totally independent, and in that regard I asked him a question. It was not a quick answer. He spent several hours at a meeting with me.

Mr. **McCollum**. Does Arthur Andersen have outside counsel?

Mr. **Miller**. Outside counsel?

Mr. **McCollum**. Do you have house counsel or somebody you go to to ask legal questions to?

Mr. **Miller**. We have house counsel.

Mr. **McCollum**. Do you ever ask them about a problem that comes up with an illegality in a client situation? Do you ever go to them and ask them?

Mr. **Miller**. Occasionally.

Mr. **McCollum**. I gather you're saying the auditing standards that you've listed here don't require you to do that even when you suspect illegality; is that correct?

Mr. **Miller**. If we were not satisfied after talking with Mr. Rae, I then had another choice. I could have gone to my own counsel, I could have qualified the opinion or resigned the account. Those would——

Mr. **McCollum**. All right. With all due respect to whatever your qualifications and how excellent a job you may have done in every other way, I think you exercised extremely poor judgment in reaching that conclusion.

Thank you, Mr. Chairman.

Mr. **Hughes**. The gentleman from Kentucky.

Mr. **Mazzoli**. Thank you, Mr. Chairman.

I've arrived late and I apologize to the panel, but the one area which may have been gone into or not was one that I asked Mr. Peller before we broke for lunch, and that was, how wrong am I in suggesting that there seem to be in your testimony the hint that if 50 million people do it a certain way then it's right, even though you may have personal feelings about it to the contrary. Because you mentioned that 40-some-odd of the brokerage outfits use a certain kind of accounting, and it seemed to me then, and I would ask you again now, that there does appear to be a disposition on the part of the accounting profession today which seems to me to be a turning away from its tradition of the past to be a very zealous guard of truth, and honesty and probity, to the point now where if everybody does it, even if it's skating on thin ice, we'll approve it.

Now, tell me how wrong or how right I am in that thesis.

Mr. PELLER. Mr. Mazzoli, I think the fact that we raised this issue back in connection with the 1979 audit suggested that the company expand the caption to, in our view, more accurately describe the situation that existed in 1979, the fact that the financial statements reflected on their face rather than buried in a footnote the fact that the company had a significant book overdraft I think, from our perspective, says that we exercise and we are very concerned about professional responsibilities. And, so, I guess I would say yes to the sensitivity.

Mr. MAZZOLI. I'm not an accountant, as my friend from Florida is, and I'm not really sure, but I mean, do you do things differently than when you entered the profession? I mean, are young accountants given discretion and leeway to judge a company's performance not so much against the strict standards of maybe the canons of the profession but to look around, too, and take a look at what the other guys are doing, and if they're doing it, then maybe that's at least one aspect in their favor along with other things. I mean, are they taught differently than when you were taught in school?

Mr. PELLER. Mr. Mazzoli, to use, I guess, one of the things my wife once asked me in terms of what I did, she said, "Gee, if it's all in the books, what do they need you for?" And the fact of the matter is, that things aren't quite that precise. But in this particular area, the area of book overdrafts, as we indicated in our testimony, this is an area that's been relatively constant from an accounting principle disclosure standpoint, going back to the time when I was in school. And, in fact, one of the quotes that we have in our testimony was out of a textbook that we used when I was——

Mr. MAZZOLI. When you were in school.

Mr. PELLER [continuing]. When I was in school.

Mr. MAZZOLI. So, apparently, it's not unusual in this ethereal region of the corporate boardrooms to sort of condone a fairly steady routine, a program practice of overdrawing your bank account? Is that the case?

Mr. PELLER. The notion of aggressive cash management—and I'm not dealing now——

Mr. MAZZOLI. Well, that is, of course, a euphemism, and I guess we have to deal in euphemisms, but——

Mr. PELLER [continuing]. About where you—I don't know where you draw the line. I mean, that's a very difficult issue.

Mr. Mazzoli. Well, how about drawing it—I mention this thing and I realize that what we do in Kentucky and what I've always done is maybe not a posit, but how about drawing the line at $404 million? I mean, doesn't that excite a certain amount of curiosity?

It isn't like you have $404 or maybe $40,400 that may be overdrawn at the end of some periodic year or some accounting period, but $404 million. It may stay steadily there, because it was $351 one time and $260 another time. I mean, that's a steady figure, so it doesn't vary much. But you're talking about some fairly big money, and should that not have aroused some curiosity?

Mr. Peller. I think the fact is that it did arouse the curiosity, and the background of that I think we've described in terms of what happened in connection with the 1979 subsequent audits.

Mr. Mazzoli. Maybe I can—because I don't want to take more time than my 5 minutes—let me bring you up to today.

Mr. Peller. OK.

Mr. Mazzoli. If someone paraded into your office now, and you did an audit on them, there was a $404 million account, what do you do now that you might not have done in 1981?

Mr. Peller. One of the things that's come out of the *E.F. Hutton* case—I'm now speaking very broadly in terms of auditors in general and of Arthur Andersen more specifically as a firm. There's a lot more sensitivity that exists today than, quite frankly, existed a year or two ago. The basic thing that we're hearing right now, there's a lot of going back to this question of signal—and I'm not saying it's good or bad, or that it should be or shouldn't—but the fact of the matter is that corporate treasurers, corporate senior executives, chairmen of the board, boards of directors, and audit committees, are asking those questions and we're asking those questions as part of our——

Mr. Mazzoli. If I were to take a look at some of the records and some of the audits that you've just conducted, is there anything that approximates this with a footnote to describe some $404 million overcharge or underpayment? I mean, are you still doing the same thing with just a little bit more sensitivity or are you drawing the line with your clients and saying, "Look, if you make us have to certify this, then look for somebody else?"

Mr. Peller. I think the issue is not the line in terms of the number, as we gather, but rather the practices of the company. It may well be that, for example, a company that has a $400 million book overdraft has a zero balance arrangement with a bank—Bank of America, or City Bank, or whatever. There may be absolutely nothing inappropriate about that arrangement. And so, it's not so much the arrangement in terms of its absolute dollars but rather, as we gather, reading press accounts and so forth—and we're not lawyers, but in reading those accounts, it seems to me that it's the procedures, the practices of the companies that are more in focus rather than the absolute dollar amount of the overdraft.

Mr. Mazzoli. Well, I guess, I gather from this that you would feel, as a professional, no problem in doing what you did with E.F. Hutton. The only thing you feel differently now is that from the public relations standpoint, from the worry that this may not be as ethical or as proper as it should be, that we're sort of backing off a little bit. But you apparently still don't see any real problem with what E.F. Hutton did. I mean, you as a professional stand behind the way that they—I think if I use the professor's words, they euchred, they flim-flammed, they kited—I mean, you still stand behind what they do?

Mr. PELLER. I would not use those words to describe what was done. I think from a financial reporting standpoint, we feel, and still do, that the financials in those years clearly highlighted the notion that they had a book overdraft.

Mr. MAZZOLI. The last question that I would ask, Mr. Chairman, is this.

You mentioned, Mr. Peller, that because, in a sense, other people did it, other people in the industry, other companies did it, and, in a way, that sort of justified what was being done, were other companies doing it to the extent of hundreds of millions of dollars? I mean, were they not only consistent in their description but consistent in the numbers?

Mr. PELLER. Mr. Mazzoli, the "it" meaning did the companies have large book overdrafts?

In the exhibit that is attached to our statement, we have a company with $596 million of book overdrafts, $277 million of book overdrafts, $164 million, $133 million. I can't tell you exactly. These are large amounts. They are very common in the brokerage industry. That's not to suggest that there's a conspiracy or a great illegality going on. I don't think that these numbers are intended to reflect that.

Mr. MAZZOLI. Mr. Chairman, thank you very much. I guess I'm driven to the conclusion, though, and I would, with great respect, because we had people from E.F. Hutton at the very same table, and the combination of using elegant words, and phraseology, and what I then called plausible deniability, everybody reaches the plateau where nobody is at fault, nobody's done anything that even has any semblance of wrong or of mischief connected to it. And we know that millions of dollars were kind of thrashed here, and pushed there, and dropped there, and pulled here, and yet, nobody seemed to think anything was wrong and everybody remains intact, almost virginial in their professional characteristics, and I find that amazing, what we've seen.

Mr. PELLER. Mr. Mazzoli, if I might just say, we're certainly not endorsing illegal behavior. I think what we're trying to say is that the auditor's responsibility is the financial reporting.

Mr. MAZZOLI. I thank you.

Thank you, Mr. Chairman.

Mr. HUGHES. The gentleman from Florida, Mr. Shaw.

Mr. SHAW. Thank you.

Mr. HUGHES. Five minutes.

Mr. SHAW. Mr. Miller, you were the one who first pointed this up and you're the guy getting beat up today. I'd like to talk to you just a minute about 1980 again.

The question has come up, and it seems to be that that is being used as a base year when there wasn't any illegal action. Looking back from this vantage point, do you feel that that's the case?

Mr. MILLER. Sir, I came across the fact that Hutton was transferring large amounts of money——

Mr. SHAW. All right, let's start there.

Mr. **Miller** [continuing]. Between branches.

Mr. **Shaw**. All right, let me start there and sort of walk through it, because this whole thing is extremely confusing as to exactly what was happening.

They were anticipating deposits, customers' money, and writing checks on that, and getting it out to their own bank at that point.

Mr. **Miller**. Yes; basically what I found were a lot of interbank transfers from the branches to the regions, from the regions to the home office, and occasionally from the home office back to the branch.

Mr. **Shaw**. Home office back to the branch is when the greed set in, as I understand the issue.

Mr. **Miller**. This is the way——

Mr. **Shaw**. Does that go in all of 1980?

Mr. **Miller** [continuing]. Mr. Sullivan explained the system, that there were situations where they would reimburse the branch, valid situations, and that he felt—and Mr. Rae, then, opined on this particular aspect.

Mr. **Shaw**. That was only to cover—the checks going back were only to cover if a customer's check had bounced or something else back in 1980, wasn't it? Or was this whole kiting scheme going on at full blast back in 1980?

Mr. **Miller**. No; at that time I believe there was some type of valid multiplier effect being used as well.

Mr. **Hughes**. Would the gentleman yield to me for just a minute?

Mr. **Shaw**. Yes; I yield, sir.

Mr. **Hughes**. Just so the record's clear, my colleague is talking about the period 1980. I have your summary of cash, your worksheet, which goes back to the period back in 1980, and, in fact, the audit as of December 21, 1981, in which your auditors did pick up the fact that, for instance in the United Virginia Bank there was only $3,500 on account, and there were outstanding checks of $9.7 million.

Mr. **Shaw**. Now, back in 1980 they were doing the 1979 audit. So are we in the same year?

Mr. **Hughes**. Yes; the audit is as of December 31, 1981.

Mr. **Shaw**. Yes.

Mr. **Hughes**. I presume it's for the period immediately prior to that.

Mr. **Shaw**. Yes, but that would be in 1982 that that audit was going on.

Mr. **Miller**. Sir, I believe I confirmed that account with United Virginia Bank and received nothing in 1981 from the bank other than the normal information, I believe, from the schedule.

This was the very point we discussed, the means to pay, the fact that Hutton had between $½ billion and $1 billion in liquid assets available to pay, the fact that they had lines of credit over $½ billion. They had resources to pay large checks. This is what we were informed of, that they had the means to pay.

Mr. **Hughes**. Would the gentleman yield further?

Did you find out at that time how they were going to satisfy that kind of an overdraft?

Mr. **Miller**. Well, just looking at their financial statements, you can see that their current assets, if you will, their securities investments, their Government investments, when compared to their——

Mr. **Hughes**. So you buy the argument that if I have ample assets and I only have $200 in three bank accounts, I can draw down $5,000? As long as I cover it when it's presented for payment I'm doing something legal?

Mr. **Miller**. If attorneys advised me that was legal, sir, I'm not——

Mr. **Hughes**. Well, we call that kiting. As a prosecutor I prosecuted people for kiting checks.

What's the difference between what occurred here—and you described this kiting. As a matter of fact, you attended a meeting in 1982 when it was described as kiting of the Genesee Bank; isn't that true? It was described as kiting.

Mr. **Miller**. I don't see it in here, sir. Maybe——

Mr. **Hughes**. Well, I'm referring to a memorandum of interoffice communication, December 13, 1982——

Mr. **Miller**. February 25——

Mr. **Hughes** [continuing]. "Discuss current legal matters, including a Harrisburg, PA, check-kiting investigation," stating that two postal inspectors reviewed Arthur Andersen & Co.'s work papers for 1980 and 1981. You were aware of that. You were present when it was described as "check kiting," were you not?

Mr. **Miller**. May I just see the memo, sir?

The other memo doesn't refer to it.

Sir, this was at an audit committee meeting in December 1982. I don't know who led this discussion from my version of the memo, but it seems——

Mr. **Hughes**. Well, weren't you aware of the fact that it was basically check kiting?

Mr. **Miller**. No, my definition——

Mr. **Hughes**. What's the difference? What's the difference between what they did here and check kiting? You tell me what the difference is.

Mr. **Miller**. It's my understanding that in check kiting, in Professor Briloff's submission there is an example of check kiting, where, on a particular day, an entity draws a check from one bank to another bank, deposits it in the second bank late in the day, such that it won't get in to clear at the first bank, and, as a result, they make no entry on their financial statements whatsoever, and they simply put money into a bank account and not record the fact that they had dispersed it from another.

In this particular situation, sir, Hutton recorded that liability on——

Mr. **Hughes**. So the distinction you make is that if I make a record of that, I'm OK. So, if I have three bank accounts, and I have sufficient resources to cover a $1 million check, and in those three bank accounts I only have $5,000, if I draw down on the one bank $500,000 and I use a check on a second bank and cover that before it's paid, assuming it's going to take 3 days to clear or 4 days to clear, and then I make sure that I use the third bank to cover that third check and I keep going that cycle, keep that going as long as I keep covering those accounts, that that's OK. Is that what you're telling me?

Mr. **Miller**. That is the reason I raised the question in the first place, sir.

Mr. **Hughes**. Well, I know you raised the question, but I'm asking you if that's OK. You're here telling us that you think that that's accepted practice as long as I have the wherewithal to cover.

Isn't that what Tom Rae told you?

Mr. **Miller**. I believe it's a legal matter. And, in fact, today it may be illegal, but at that time I was informed that since they had the means to pay, and obviously had the means to pay, that it was legal.

Mr. **Shaw**. I think that's, Mr. Chairman——

Mr. **Hughes**. I thank the gentleman.

Mr. **Shaw** [continuing]. Is pointing out the real problem, that we're sitting here as a panel of lawyers, and we are looking for violations of the law, and we're looking at who knew what the violations of the law were.

And, in fact, unless it hits you between the face, you're looking at the question of whether the financial statements present fairly the financial condition——

Mr. **Miller**. Right.

Mr. **Shaw** [continuing]. And the results of operation.

Quite obviously, there was a contingent liability there which has come home, and it was building up over the years, which ended up in the form of a settlement. And there may be a lot more liability out there, yet. But the banks, themselves, were clearing those checks and allowing that money to be used before they really should have. And because of the prestige of the Hutton account, we're allowing them to get away. I know I can't put $100,000 and go down and start drawing on it before it clears, and I doubt if anyone in this room could without some special arrangement with the bank.

But it seems that E.F. Hutton was doing that, and the banks were allowing them to continue to do that. Is that not correct?

Mr. **Miller**. It's my understanding, from what I know now; yes.

Mr. **Shaw**. And you said that your understanding of what your responsibility was is whether or not there were sufficient current assets to cover it, so that you go back to the question, then, as to the financial condition and whether the books presented fairly.

Now, I would disagree with you very stringently on this one. I think the name of the account was a gross error, and I'm sure that you have rethought that one a hundred times and I won't dwell on that. But the word "draft" is such a broad term that I think the use of that on an overdrawn bank account is really not a good usage of the term, because it can mean several things and mean different things to different folks. So, I think that when you talk about presenting fairly, I think that presents a real question as to whether that does present accurately and fairly as possible.

I agree with you, as far as the use of the footnotes, people, unfortunately, don't read those footnotes; but I think if the accounts' names are not specifically set forth to your complete satisfaction, and I mean complete satisfaction, that as independent certified public accountants, that you would have an obligation to mention that point in your opinion letter.

Mr. PELLER. Mr. Shaw, if I just might, one of the schedules that we've provided to the staff previously is a schedule which breaks down, at their request, the components of the caption "drafts and checks payable." And, in fact, even in years subsequent to 1979, Hutton did continue to issue drafts. They also issued checks. And that was the reason for the notion of continuing the disclosure of "drafts and checks payable," they, in each year, had $1½ million, $5 million, $2 million, and so that's the reason that the caption, rather than solely saying, for example, "checks payable"——

Mr. SHAW. Yes, sir. But in looking at the statement that you have, the "drafts payable"—and "draft payable" does, in itself, suggest that the money may not be there, that the demand is yet to be completed. But the "drafts payable" was a very small portion——

Mr. PELLER. Yes, it was.

Mr. SHAW [continuing]. Of that total account; which I think, in itself, was somewhat misleading to include that.

And I think the fact that there are different instruments created some real problems as far as giving the complete financial picture.

Mr. PELLER. But in both instances, as you indicated, the funds are not in the bank. When you issue drafts or you issue checks payable you are back to the same.

Mr. SHAW. But the "draft payable" indicates there's probably an agreement out there, and that's the problem, and that's where we get stumbled up. And if the bank has agreed to this system, then that's one thing, but in this particular situation the banks didn't even know.

Mr. PELLER. One of the largest components—again, going back to that analysis—of the "checks payable" is the amount represented by overdrafts and zero balance accounts. And those were specifically arranged with the five major banks: Bank of America, Chemical Bank, U.S. Trust Co., and so forth.

Mr. SHAW. Yes, sir. But we're talking about 400 to 600, many of them country banks. We're not talking about the sophisticated New York banks.

And, by the way, those banks that you are talking about, you did have the agreement with, they knew exactly what was going on, and Hutton would be under an obligation to run to the bank and cover those things very quickly. And I assume, under most instances if not every instance, they covered them before they were paid; is that not true?

Mr. PELLER. We had no indication in our audit work that they did not do that. That's correct. Nor did we get any indication that, through confirmation process or otherwise, the checks were bouncing in those banks or any other banks.

Mr. SHAW. I guess another thing that we should be thinking about here, what we're really talking about is who's making the money on the float. Now, there's two kinds of floats involved, and, of course, the banks have been short-changed because they feel that they should have been making the money on the float. And Hutton came up with the scheme where they were making the money on the float.

Did you all have a chance or occasion to look at customers' accounts, to see if some of these, if these amounts were being delayed so that Hutton was making profit on these while the money was still in the pipeline?

Mr. **Miller**. Sir, each year we confirm several thousand customers' accounts.

Mr. **Shaw**. What's that?

Mr. **Miller**. Each year we confirm several thousand customers' accounts, in that regard, to get a full statement of their transactions, and it does show in that statement the date the check was dated. And we didn't get any exceptions from the customers saying they weren't paid on that day or anything of that sort.

In addition, of course, because of the Securities and Exchange Commission's rules for customer protection, we thoroughly audited and reviewed the controls, and, in fact, opined on the controls. We did extensive work on the internal control of customers' accounts, the segregation computation where Hutton each day—each week—segregated the excess of payable to customers over receivables to customers. And those funds, when there was a requirement, were segregated in special accounts exclusively for the benefit of customers. And we confirmed that with the banks, that those funds did not have the right of offset or anything else.

Mr. **Shaw**. So you are convinced, or at least your audit would certainly indicate, that Hutton was not making profit by delaying of the customers' moneys coming——

Mr. **Miller**. To my knowledge, based on our responses, no, sir.

Mr. **Shaw**. Thank you, Mr. Chairman.

Mr. **Hughes**. Thank you.

I want to put in the record the "Illustration of Accounting for Book Overdrafts," submitted by E.F. Hutton.

Without objection.

[The document referred to follows:]

ILLUSTRATION OF ACCOUNTING FOR BOOK OVERDRAFTS

	BANK			
	A	B	C	TOTAL
BALANCE PER BANK	$300	$100	$-0-	$400
CHECKS ISSUED & OUTSTANDING	[100]	[120]	[300]	[520]
BALANCE PER BOOKS	$200	[$ 20]	[$300]	[$120]

FINANCIAL STATEMENT PRESENTATION

ASSETS		LIABILITIES	
CASH	$200	CHECKS PAYABLE	$320

E.F. Hutton and Company Inc.

Major Components of Drafts and Checks Payable

(In Thousands)

Year Ended December 31	Drafts Payable	Checks Payable: Zero Balance Accounts	Checks Payable: Other Overdrawn Accounts	Total Drafts and Checks Payable Per Audited X-17A-5
1979	$1,547	$84,375	$180,530	$266,452
1980	$5,225	$100,303	$259,108	$364,636
1981	$1,991	$124,992	$207,764	$334,747
1982	$2,041	$94,814	$51,356	$148,211
1983	$4,100	$254,957	$176,912	$435,969
1984	$3,336	$259,216	$142,792	$405,344

Mr. Hughes. I'd like to place in the record an analysis of the E.F. Hutton "Accounts of Major Components of Drafts and Checks Payable for the Period 1979 through 1984," which shows a breakdown of drafts payable and other overdrawn accounts.

Without objection?

Mr. Shaw. Yes, sir. No objection.

[The document referred to follows:]

E. F. Hutton

Analysis of Checks Payable by Bank

YEAR	CUSTOMER	CUSTOMER	VENDOR	PAYROLL	DIVIDEND	TOTAL
1979	$ 68 884 (Bank of Amer)	—	$ 7 782 (Wachovia)	—	$ 7 709 (B of A)	$ 84 375
1980	76 992 (B of A)	—	7 559 (Wachovia)	7 379 (Chemical)	8 373 (B of A)	100 303
1981	72 113 (Bank of Amer)	29 501 (U.S. Trust)	10 434 (Wachovia)	4 000 (Chemical)	8 944 (Bank of Amer)	124 992
1982	33 415 (Bank of Amer)	34 234 (U.S. Trust)	12 482 (1st Atlanta)	4 150 (Chemical)	10 531 (B of A)	94 814
1983	107 090 (Bank of Amer)	104 408 (U.S. Trust)	26 227 (1st Atlanta)	7 522 (Chemical)	9 710 (B of A)	254 957
1984	120 154 (Bank of Amer)	85 825 (U.S. Trust)	27 038 (1st Atlanta)	10 154 (Chemical)	16 005 (B of A)	259 216

Mr. **Shaw**. The other one you said was submitted by Hutton. I know you meant to say Arthur Andersen.

Mr. **Hughes**. I'm sorry about it. Yes, Arthur Andersen. I'm sorry. The record stands corrected.

Also, I would like to put in the record a memorandum, Arthur Andersen interoffice communication, dated December 13, 1982, relating to a telephonic meeting of E.F. Hutton Group, involving Joel Miller and John Tesoro representing Arthur Andersen.

Without objection, so ordered.

And finally, an interoffice memorandum dated December 13, 1982. which describes the check kiting investigation, stating that two postal inspectors reviewed Arthur Andersen's worksheets, signed by John Tesoro, who I understand, is with Arthur Andersen & Co.

Mr. **Miller**. Yes, sir.

Mr. **Hughes**. Without objection, so ordered.

I just want to pick up briefly, and I'm almost finished.

With regard to the drafts and checks payable, and the confusion that that entry, in my judgment, conveys, wouldn't it have been far preferable, since "drafts payable" represented such a very small part of the drafts and checks payable, wouldn't it have been better to have separated those two items?

Mr. **Peller**. I think, Mr. Chairman, the idea of presenting a compound caption, that is "drafts and checks payable," basically was responsive to that notion, to set out—remember now, Hutton's balance sheet reflects total liabilities in capital of something like, say, $15 billion.

Mr. **Hughes**. But they are two different types of legal instruments.

Mr. **Peller**. That's correct.

Mr. **Hughes**. The "draft payable," that suggests that there are agreements involving that. That's a promise to pay in the future when presented. You're talking about "checks payable," that presumed that there are deposits and are payable when presented for payment, they are in circulation.

Why wouldn't it have been preferable to have two separate entries?

Mr. **Peller**. It may well have been, but only in the sense that to set out a $2 million item on the face of the balance sheet that had footings of $15 billion, very often financial statements present such information on a summarized basis and that was an attempt to reflect this data on a summarized basis.

Mr. **Hughes**. You know what really, in the final analysis, concerns me about your role, is that you were on notice that there might be something wrong in 1980, and you brought it to management's attention. Subsequently, you found that there were other things wrong, you found overdrafting by sizable amounts, you became aware of the check-kiting investigation in 1982 by a Federal grand jury, and yet, in your interoffice memoranda—and I offer for the record a memorandum dated February 25, 1982, an interoffice memorandum marked "strictly confidential"—which, on the second page—and it is signed by you, Mr. Miller, and John Tesoro—you indicate that concerning the questions of overdrafting and the checks payable far in excess of the asset cash, you refer back to the meeting in 1980, saying, "We were told back then it's OK."

[The documents referred to follow:]

A A & CO.
[illegible]
Printed U.S.A.

#2

EF Hutton
o/c File

INTEROFFICE COMMUNICATION

NEW YORK OFFICE

DECEMBER 13, 1982

MEMORANDUM TO THE FILES

SUBJECT: AUDIT COMMITTEE MEETING, DECEMBER 10, 1982

A telephonic meeting of The E.F. Hutton Group Inc. Audit Committee was held on December 10, 1982. Present in attendance were several members of Hutton senior management, including Thomas Lynch, Norman Epstein, Paul Hines and Thomas Rae. Attending via conference call were the members of the Committee: Edward Cazier, Warren Law and Bud Crary. Joel Miller and John Tesoro represented AA&Co.

INTEROFFICE COMMUNICATION

Professional Education Department. He also discussed current legal matters, including the Harrisburg, Pennsylvania, check kiting investigation, stating that two postal inspectors had reviewed AA&Co.'s workpapers for the 1980 and 1981 audits.

JOHN M. TESORO

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Attachment

#1

INTEROFFICE COMMUNICATION

Hutton Gra
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F.LE

NEW YORK OFFICE

FEBRUARY 25, 1982

STRICTLY CONFIDENTIAL

MEMORANDUM FOR THE FILES

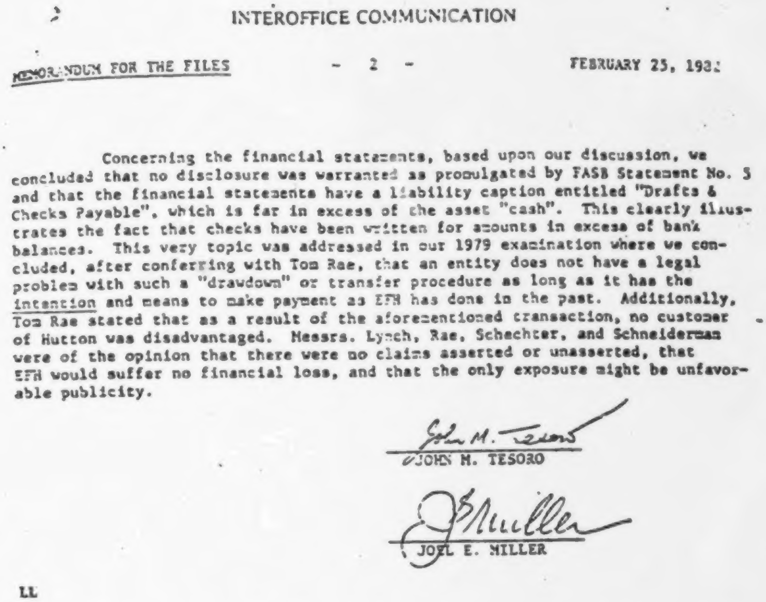
SUBJECT: TRANSFERS OF FUNDS

On February 25, 1982, Joel Miller and John Tesoro met with Tom Lynch (Executive V.P.), Tom Rae (Executive V.P., Legal) and Loren Schechter (Senior V.P., Legal) as well as Irwin Schneiderman of Cahill, Gordon & Reindel to discuss a situation concerning Hutton's policy of transferring cash balances between banks as well as "drawing down" cash from Hutton's branches to regional headquarters and finally to New York. It was brought to the attention of Hutton management that checks written on a bank in upstate New York had "bounced" as a result of "drawing down" balances for which subsequent deposits had not been made by the time such checks cleared. In addition, it was also brought to Hutton's attention by the New York State Banking Regulators that a significant amount of transfers took place between Manufacturers Hanover Trust and Chemical Bank in late December and January.

Concerning the first issue, Tom Rae stated that overdraft situations at the local bank should never have occurred and that the personnel responsible have been notified as to Company policy concerning drawdown procedures at the local bank level. Mr. Rae stated that the bank involved desires to continue doing business with EFH and did not seek to charge Hutton interest on the overdrawn balances (in answer to Joel Miller's question).

As far as the second issue is concerned, the Banking Regulators and the Federal Reserve Board expressed concern over the controls of Manufacturers Hanover concerning transferring of large balances when, in fact, there may not be sufficient funds to cover these transfers (i.e. from a credit risk point of view). Additionally, the Fed also apparently expressed concern over "creating float" as opposed to taking advantage of the float inherent in the banking system. We were assured of the fact that no action has been brought against Hutton nor unasserted claims, and in fact, the banks have not "lost" in the sense that EFH leaves money on deposit in the normal course of business (albeit not formal compensating balance arrangements).

Messrs. Schneiderman and Rae went on to state that Hutton is not regulated by the Fed or the New York State Banking Regulators and that this was more of a banking issue. They stated, however, that it was possible the SEC could have been notified of such occurrences. The major concern of management was potential negative publicity if the media were informed.



INTEROFFICE COMMUNICATION

MEMORANDUM FOR THE FILES - 2 - FEBRUARY 25, 1982

Concerning the financial statements, based upon our discussion, we concluded that no disclosure was warranted as promulgated by FASB Statement No. 5 and that the financial statements have a liability caption entitled "Drafts & Checks Payable", which is far in excess of the asset "cash". This clearly illustrates the fact that checks have been written for amounts in excess of bank balances. This very topic was addressed in our 1979 examination where we concluded, after conferring with Tom Rae, that an entity does not have a legal problem with such a "drawdown" or transfer procedure as long as it has the intention and means to make payment as EFH has done in the past. Additionally, Tom Rae stated that as a result of the aforementioned transaction, no customer of Hutton was disadvantaged. Messrs. Lynch, Rae, Schechter, and Schneiderman were of the opinion that there were no claims asserted or unasserted, that EFH would suffer no financial loss, and that the only exposure might be unfavorable publicity.

John M. Tesoro
JOHN M. TESORO

J E Miller
JOEL E. MILLER

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Mr. HUGHES. I really find it hard to comprehend how, at that stage, when there's a Federal grand jury impaneled, looking at it, you still conclude that Mr. Rae, an old friend, said it was OK, you have faith in him and so it's OK. No further questions asked.

Mr. MILLER. No, sir, if I may. I was at a meeting—first of all, I've had a professional relationship with Mr. Rae. he is the general counsel of E.F. Hutton.

Mr. HUGHES. He also happens to——

Mr. MILLER. There was no grand jury at that particular time.

Mr. HUGHES. He also happens to work for E.F. Hutton.

Mr. MILLER. But, sir, there was no grand jury February 25, 1982. It wasn't until later in the year that the postal inspectors arrived at our offices, and that matter was subsequently reported to the audit committee, and——

Mr. HUGHES. The Genesee Country Bank investigation was underway at that time.

Mr. MILLER. Well, that's what we were told. That was the precise purpose of this memo and this meeting, was to inform us of that. And then, thereafter, the postal inspectors arrived at our offices. Thereafter it was brought to the audit committee's attention, and then again at the committee.

Mr. HUGHES. Well, Mr. Miller, what did you then do to double check Mr. Rae's opinion? Did you consult outside counsel?

Mr. MILLER. Outside counsel was at that meeting, sir, in February.

Mr. HUGHES. Did you consult counsel to get an independent opinion?

Mr. **Miller**. We discussed the topic, to my recollection. It was discussed at that meeting with Hutton's outside counsel.

Mr. **Hughes**. Did you check with any of the banks that they were doing business with, where the overdrafting was taking place, to determine whether or not they had an arrangement with E.F. Hutton?

Mr. **Miller**. We sent over a hundred confirmations a year.

Mr. **Hughes**. Well, that doesn't——

Mr. **Miller**. You know, Mr. Chairman——

Mr. **Hughes**. Don't say that. That doesn't, that won't tell you a thing. The banks didn't know what was going on at that point. The only banks that knew about it were Genesee County Bank and a few others who demanded restitution.

Mr. **Miller**. We were told about them, and outside counsel was there, inside counsel was there. They didn't—and, in fact, in an audit committee meeting we were told that what Hutton was doing was legal, at a subsequent audit committee meeting.

Mr. **Mazzoli**. Mr. Chairman.

Mr. **Hughes**. The gentleman from Kentucky.

Mr. **Mazzoli**. Thank you, Mr. Chairman.

I just want to mention that sort of in that same connection, staff hands me a memo which suggests that, Mr. Miller, you were told by Mr. Rae, a representation as made to you, that the Genesee Country Bank was delighted to continue being with E.F. Hutton, they thought they were great people. It turns out that that was exactly contradictory later on and Rae was shown to have lied, essentially speaking.

Do you still feel that you can afford now or in the future, and should have then relied upon, I think as professor colorfully said, the foxes that were circling the chickens? I mean, isn't that exactly what Rae and inside—I don't care what you call it, inside, outside, upside-down side, counsel, those people are out protecting their turf.

And I think what we're asking, and I think, Mr. Chairman, the part that intrigues me, in answer to what my friend Mr. Shaw said, that essentially speaking we, the panel, are looking at it as lawyers to try to find wrongdoing.

In fact, you guys are looking at it just to see that the books are straight. Well, I hope to God a CPA does more than just seeing that the bottom line is four is when you've got two and two. I'd like to think that you've got some interest in how you achieve the two and how the two was acquired——

Mr. **Miller**. I agree.

Mr. **Mazzoli** [continuing]. Not that they balance at four. And I think that the part that bothers me greatly, and I think the chairman has brought it up, is the worry that we have that, along with the professor, his admonition that we may have a profession, CPA, accountancy, which has lost its moral compass, which doesn't any longer look behind the thing, it just takes whatever is delivered, it becomes part of the enterprise.

And my question, at one point, was going to be if you all are involved financially with anything E.F. Hutton is involved. I think it is a legitimate question, and you shouldn't frown; it is very legitimate. Are you--if you're going to be an auditor, for the public's benefit you should not and cannot be financially involved in anything E.F. Hutton does. And I ask the question: Are you all involved in any fashion?

Mr. Peller. We have very strict independent standards, both within the profession, Mr. Mazzoli, and also within our firm. None of our partners or employees, for example, can own securities of E.F. Hutton or any companies they are involved in. We cannot invest in any ventures that are promoted by E.F. Hutton where they function as a general partner. We are permitted to have only cash securities accounts with brokerage firms. And we cannot, for example, enter into margin transactions with a client in the brokerage industry.

Mr. Mazzoli. Thank you, Mr. Chairman. I just wanted to bring out that part about the Genesee Country Bank, because it shows that Mr. Rae certainly——

Mr. Hughes. I think it's a good. It's a good point.

Mr. Miller, apparently you and Mr. Tesoro had a great deal of contact with E.F. Hutton.

Mr. Miller. Yes, sir.

Mr. Hughes. Were you in charge of the account basically?

Mr. Miller. Yes, sir, I was.

Mr. Hughes. When did you become aware of the aggressive overdraft?

Mr. Miller. I became aware of Hutton's money management system in 1979. I believe I might have focused a little bit on it in 1978, but in 1979 I focused on it, and that was the meeting——

Mr. Hughes. Are you aware of the manner in which they stepped up the aggressive overdrafting? Were you aware of that?

Mr. Miller. No, sir.

Mr. Hughes. You never became aware of the fact that they were writing huge checks with little on deposit in 1982?

Mr. Miller. Huge checks?

Mr. Hughes. Yes.

Mr. Miller. I'm sorry, I didn't hear you.

Mr. Hughes. I mentioned the United Bank of Virginia as one example. They had $3,500 in the bank and they wrote a check for, what was it, $9 million?

Mr. Miller. These type items—that particular item—I see on the schedule now, sir, but I don't recollect. But the fact that there were interbank tranfers was the very item I brought to their attention. This was the reason for the concern.

Mr. Hughes. Did you know that they were using a zero balance account to cover that?

Mr. Miller. No, sir.

Mr. Hughes. Did you audit the zero balance account?

Mr. Miller. Yes, sir.

Mr. Hughes. What did you think the zero balance account was being used for?

Mr. Miller. I thought it was being used to pay customers and other things.

Mr. Hughes. Did you ever examine the checks?

Mr. Miller. Arthur Andersen, yes.

Mr. Hughes. Who were the checks mostly written to?

Mr. MILLER. I don't remember. No, they were working in accordance with the way we were informed they were.

Mr. HUGHES. So you just take it from there?

Mr. MILLER. No; they were working in accordance with the way we were informed they were.

Mr. HUGHES. Where do you become independent auditors? I mean, you keep telling me that you were told this, you were told that, E.F. Hutton told you this, "I took their opinion and that was the basis for my ruling." When do you become independent? When do you start becoming independent, serving the public interest?

Mr. PELLER. Mr. Chairman, from our standpoint, when we looked at the interbank transfer schedule, which is a standard audit procedure, looking at transfers from one account to another, when we looked at that in the 1979 audit, we saw significant transfers among E.F. Hutton accounts. That was the independent audit procedure that you referred to. That was one of the very major elements that caused us to raise the question initially with Mr. Lynch and, subsequently, with Mr. Rae and Mr. Sullivan, it was that audit procedure.

Mr. MILLER. I brought this to very high levels within the company.

Mr. HUGHES. Who in particular did you bring it to the attention of? Give me some names.

Mr. MILLER. As indicated in one of the memos, it was brought to Mr. Lynch's attention, before that the assistant comptroller——

Mr. HUGHES. All right, give me a name.

Mr. MILLER. Mr. Larry Volpe. And then it went to Mr. Lynch. Mr. Lynch agreed to change the financial statement caption. It was brought to Mr. Shechter's attention, who is the assistant counsel at Hutton. It was brought to Mr. Rae's attention at the meeting.

Mr. HUGHES. So there's no question——

Mr. MILLER. Mr. Volpe and Mike Castellano were there, and——

Mr. HUGHES. There's no question in your mind that the management, the top management of E.F. Hutton, knew about the aggressive overdrafting. So, when they suggested that they didn't know anything about it, that's not true.

Mr. MILLER. Those individuals heard Mr.—well, Mr. Lynch was not at the meeting with Mr. Sullivan and Mr. Rae. Mr. Castellano and Mr. Volpe were there, and Mr. Sullivan explained to us and to them what the procedures were for the basic draw-down system. And then I went back to Mr. Lynch and explained that Mr. Rae said the system was legal.

Mr. HUGHES. So, when Mr. Rae says that he didn't know that this aggressive overdrafting took place, that is not accurate.

Mr. MILLER. Well, he——

Mr. HUGHES. Yes or no. Yes or no. You can answer that question very simply.

Mr. MILLER. He was at the meeting with me, and they described the procedure to us.

Mr. HUGHES. So the answer is, that's not true.

Mr. MILLER. The answer is that he heard the same thing I heard, and I was aware that they had a cash management system.

Mr. **Hughes**. And when Mr. Castellano testifies that he didn't know about the aggressive overdrafting, that's not true; is that correct?

Mr. **Miller**. He was at the same meeting with me.

Mr. **Hughes**. So, it's not true——

Mr. **Miller**. It's not true.

Mr. **Hughes** [continuing]. When he suggests that.

Mr. **Miller**. Well, I don't know what you mean by "aggressive overdrafting."

Mr. **Hughes**. We're talking about developing interest profits by drawing down checks on accounts where you don't have a sufficient balance to maximize your interest profits.

Mr. **Miller**. They were at the meeting.

Mr. **Hughes**. We all know what that means, don't we?

You see, the problem is that the top management at E.F. Hutton suggests that they weren't aware of these practices, and, I repeat, that it was "just some branches off the reservation doing things that they were never sanctioned."

That obviously is not true, is it?

Mr. **Miller**. The procedures were explained to me, sir.

Mr. **Hughes**. Thank you.

Any further questions?

Mr. **Mazzoli**. Mr. Chairman, I would just lastly say that I think you've made a very strong case.

I really, with all respect to you gentlemen, I'm sure that you've stayed within the canons of the profession, but I think you can see now how awkward it is when the canons are looked at carefully and when you see those canons displayed on the front page of a newspaper. One of the earliest pieces of advice I ever had when I went into politics was:

> Don't worry about whether it measures up to whatever standard, don't worry about whether it's OK by the House Rules; how would it look on the front page of the newspaper?

That is the way you can most tellingly describe is it right or wrong. And I guess what we're saying here is that we really don't think it looks very good and it smells worse displayed on the front page of the New York Times. It just doesn't seem as if professionals were doing what they really are sworn and charged professionally to do, which is to take care of their client, but, as Professor Briloff said, to take care of the public, too.

And I think, Mr. Chairman, your questions brought that out, and I further—of course, I made a point that when the Hutton people were sitting here, that if some obscure office in the Hutton chain were to have conquered cancer or had ended deprivation, or had solved the famine problem, I'm sure that all those wonderful people who live on Wall Street would have straightened out their Saville Row suits and they would have taken full credit for what went on down in some obscure office. But when that obscure office allegedly does some crazy antic, then somehow everybody says, "We don't even know who they are, we have never heard of this thing, we obviously are not responsible."

So, what is responsibility, is it a one-way street? I doubt it very much. It's a two-way street. And I think Hutton people have denied that other avenue of responsibility. And with respect, while you haven't quite gone that far, I think now, on reflection, you must see that you didn't aggressively pursue the public's interest, the commonwealth, in this whole thing. And I just think maybe, from these hearings, maybe something will come out.

But I am slightly dismayed to hear that apparently this practice would continue today except for the hearings that my friend from New Jersey has called, because apparently it's this publicity which has caused tremors in a profession more so than what's right and wrong. And, I mean, I think it should be that it's wrong to kite checks, it's wrong to write checks on water and not funds, and that that should have been the triggering, not my friend from New Jersey who courageously went into this area. I just think that the profession has missed an opportunity to take the leadership in the field that it created, and I just hope that you, in the future, when there's a tight call, that you resolve it in favor of the public and not your client or not the canons of the profession.

Mr. PELLER. Mr. Mazzoli, if I might, I think that we put our responsibilities to the public, to the users of financial statements, first. I think, in this particular case, I really feel, even with the benefit of hindsight, I think we went the extra yard in terms of digging back—based upon personal recollection—to an event that was reported 3 years earlier than that, in raising that issue with our client. The question of legality is something that we as auditors have, in the past, and will have to in the future, look to the legal profession to set the guidelines, if you will, as to where you draw the line. We're certainly not condoning, and would never condone, illegal behavior. We felt we acted prudently and received appropriate assurances not only from the inside counsel but from outside counsel of the company. It is a very unusual situation where an auditor ultimately winds up talking to his own counsel. The cannons of our profession suggest that one should look to the client's counsel, because matters are very complex in a cost-benefit sense. We'd be "chasing our tails" an awful lot if every time we had a legal concern we had to go to another group of people and had a redundancy built in.

Mr. MAZZOLI. I thank you.

Mr. HUGHES. I thank the gentleman. I think the gentleman made an important statement, and I just would like to just further suggest that in the future, when the E.F. Huttons and the Arthur Andersens decide that they don't have to go any further, they do so at their peril. I'm sure that you would be very happy to be without the publicity you have received in this instance.

Mr. PELLER. Oh, certainly.

Mr. HUGHES. And the fact of the matter is that public opinion is going to have a very difficult time, I think, sorting out just how independent the audit is. When you're paid by E.F. Hutton, when, in fact, you rely upon just the advice of E.F. Hutton, you rely upon representations by E.F. Hutton, I think the question of independence becomes very, very cloudy. And I think the public depends upon that independent audit and verification. And, you know, I quite agree with you, that you did initially bring it to their attention, but I think you fell far short after that in discharging what is your public responsibility.

Mr. Shaw. Mr. Chairman.

Mr. Hughes. The gentleman from Florida.

Mr. Shaw. I want to comment on what you said, but I have a question before that.

Everybody seems to say that this thing really got cranked up and got going after 1979. However, the overdraft figures do not indicate or do not substantiate that. They went from $266 million and increased substantially. Some years they actually decreased. But they increased to over $400 million.

Based upon the increase in the size of the corporation, that would actually indicate a diminution of the overdraft. Now, what's the case here, what happened? Did they get more aggressive or less aggressive?

As I understand, during this period the company grew 300 percent, but the overdraft only grew 60 percent.

Mr. Miller. I have no knowledge of—well, I don't know what the variation is, precisely. But in 1982, there was an investigation that had commenced. It is quite possible that the company did institute certain procedures, but it is pure speculation on my part. I don't know the answer.

Mr. Peller. Mr. Shaw, the other comment I would make is that some of this may depend, just because of the multiplier effect that was built into the system, into the legal system as we understand it. I don't mean the 10-times multiplier to take care of things like weekends and so forth, depending upon what day of the week the yearend fell may have had an effect upon this, but I can't say with——

Mr. Shaw. I see what you mean. It would be interesting to know that date.

Mr. Hughes. Will the gentleman yield to me?

You could clean out the system in 3 days. If you just stopped aggressively overdrafting for 3 or 4 days, why you'd be down to practically nothing—and just begin the scheme over again.

Mr. Shaw. That would be an interesting—because what we are looking at is a snapshot in time, it's nothing but; that's all a balance sheet is, is a snapshot.

Mr. Peller. And that's the role that we play in terms of looking at the balance sheet.

Mr. Shaw. I'd like to comment if I could, just one moment, on the comments that my colleagues have made with regard to the independence of the CPA's. I think the profession, when you think of all it does and the responsibility that it takes—and I'll certainly include Arthur Andersen here—I think the independence of it is phenomenal. And I'd like to comment on that, because we're not talking about that their legal judgment is phenomenal, because I'm sure that we would all say that it was not, but their independence, no one has attacked any of the figures that are contained on these financial statements, and that's what, really, they are supposed to do, that's their job, is the verification of these figures of the financial statements which are prepared and furnished to them by management.

Now, we all agree, on this panel, that we don't like the title that you gave the overdraft situation. And we may disagree with you, too, in varying degrees as to the question with regard to your responsibility and whether you went far enough with regard to what appeared to be an illegal transaction, even though we really don't know whether 1979 was illegal or not, and we're not sure of that but we know it, you know, it smells a little bit like it. And I would say, like you, Mr. Miller, we have concern about it. Of course, we have the luxury, now, of sitting up here and looking at indictments and looking at guilty pleas and things like that, which puts us in a much stronger position to judge what went on than what you had back then.

But I think it's very important, and it's vitally important for the public to realize what the independence and the function of the CPA's are to do. They're not saying that management is doing all things right, they're not saying everything's legal, they're not saying someone didn't pad an expense account or something like that, but they do take a sampling, and from their samplings they do positive verification, they run audit trails, and due to those sorts of things, they come up with a financial statement which they believe and put their opinion on, present fairly the result of operations as well as the financial condition of their company as of that date.

And I think that we, as a committee, only disagree in those two particular areas. One is the name of the account, whether it was sufficiently descriptive, and the second is—and we have disagreement up here—as to what the responsibility may have been to track this matter down fairly. But no one has indicated. There hasn't been any testimony before this committee in all hearings with regard to E.F. Hutton that says that, in general, that the financial statements did not fairly describe the financial condition of Hutton as of that date, together with the results of operation. No one has attacked that opinion, and that is the opinion that Arthur Andersen gave.

Thank you, Mr. Chairman.

Mr. HUGHES. Thank you.

Thank you very much, gentlemen. We appreciate your testimony. You've been most helpful.

Our second and final panel today consists of Mr. Paul J. Ostling, Mr. John J. Goodwin, Mr. William W. Renshaw, and Mr. Paul Beehler. Mr. Ostling has been an associate general counsel with the firm of Arthur Young since 1979, and also is the firm's national director of human resources. Mr. Goodwin directs the New York offices management support systems consulting group. His particular areas of expertise relate to financial models and litigation support engagements. Mr. Renshaw is Arthur Young's national director of treasury consulting services and specializes in cash management consulting for corporations and financial institutions. Mr. Beehler is senior vice president of financial operations for E.F. Hutton. Mr. Beehler formerly was a principal and west coast director of cash management services for the Arthur Young Co.

Gentlemen, on behalf of the Subcommittee on Crime, we welcome you here today.

Let the record indicate that pursuant to clause 2 of rule XI of the Rules of the House of Representatives, copies of the Rules of the Committee of the Judiciary and of clause 2 of rule XI of the Rules of the House of Representatives have been made available to the witnesses and are available at counsel table.

They're right there in front of you.

Under clause 2(k)3 of rule XI, you have the right to have counsel assist you if you desire during today's proceedings.

Are you accompanied by counsel?

Mr. Liggio. Mr. Chairman, Paul Liggio, general counsel for Arthur Young, appearing on behalf of Mr. Goodwin, Mr. Ostling, and Mr. Renshaw.

Mr. Hughes. Thank you. Welcome.

Mr. Beehler, are you represented by counsel today?

Mr. Beehler. Yes, I am.

Mr. Hughes. Would you identify counsel for us?

Mr. Beehler. Ms. Zoe Baird.

Mr. Hughes. Thank you.

Gentlemen, if you'll stand, I'm going to swear you under oath at this time.

[Witnesses sworn.]

Mr. Hughes. You may be seated. Thank you very much.

We have your statement, which is rather comprehensive, and it will be admitted to the record in full. We have all read your statement, so we hope that you can summarize.

Who is going to be the spokesperson initially?

Mr. Ostling. Mr. Chairman, Paul J. Ostling.

Mr. Hughes. Mr. Ostling.

Mr. Ostling. I will give a brief statement. We have each, Mr. Goodwin, Mr. Renshaw and myself, prepared very brief statements to describe what we've done——

Mr. Hughes. All right.

Mr. Ostling [continuing]. And our relationships during the course of this. And we thought if we could start, each by giving his brief statement, and then answer any questions you might have.

Mr. Hughes. That's fine. Why don't you proceed.

TESTIMONY OF PAUL J. OSTLING, ASSOCIATE GENERAL COUNSEL AND ARTHUR YOUNG'S NATIONAL DIRECTOR OF HUMAN RESOURCES, ACCOMPANIED BY JOHN J. GOODWIN, DIRECTOR, MANAGEMENT SUPPORT SYSTEMS CONSULTING GROUP, NEW YORK OFFICE; WILLIAM W. RENSHAW, NATIONAL DIRECTOR OF TREASURY CONSULTING SERVICES; CARL D. LIGGIO, GENERAL COUNSEL; AND PAUL BEEHLER, SENIOR VICE PRESIDENT, FINANCIAL OPERATIONS, E.F. HUTTON, FORMERLY PRINCIPAL WEST COAST DIRECTOR OF CASH MANAGEMENT SERVICES, ARTHUR YOUNG & CO.

Mr. Ostling. I am an associate general counsel at Arthur Young & Co., and I have worked with all of our teams which provided services to Hutton and to Cahill Gordon, between June 1982 and the present. I reviewed their major reports, I acted as a bridge between Arthur Young and counsel during that time period. Mr. Goodwin is on my right, and he is a partner-level consultant in our New York office. He is that office's director of management support systems consulting group. On my immediate left is Mr. Renshaw. He is also a partner-level consultant in our New York office, and he's our national director of our treasury consulting group.

At the end is Mr. Beehler, who until late June of this year was a principal in our San Francisco office, and was the west coast director of our treasury consulting group.

Mr. Chairman, Arthur Young appreciates the opportunity to be present today to testify about its role as consultant to Cahill Gordon, and its client, E.F. Hutton.

There has been wide coverage in the media about the E.F. Hutton's cash management problems, but unfortunately Arthur Young's role has not been accurately portrayed. We would like to set the record straight today.

We have been encouraged to come here today by E.F. Hutton, which has waived its attorney-client privilege, by Cahill Gordon, which has waived the attorney work-product doctrine, and by Hutton's special counsel, O'Melveny & Myers.

Arthur Young's engagements at the start with respect to cash management were for Cahill Gordon. These were what we regard as litigation support engagements. All of our engagements for Cahill Gordon have been with the objective to assist Cahill Gordon in providing legal services to its client, E.F. Hutton. We were retained by Cahill Gordon in June 1982, after the Government's investigation had commenced and after the time period in which Hutton has announced that it ceased the practices which were cited in the Department of Justice's information on May 2, 1985.

When we were retained by Cahill Gordon, we were not informed of the existence of a criminal investigation, or the types of the cash management abuses which were being investigated. All we knew initially is that we were being retained to provide assistance to Cahill Gordon, which was serving its client, E.F. Hutton, in a legal matter relating to cash management.

Prior to our retention by Cahill Gordon in June 1982, we had performed no cash management consulting engagements for either Hutton or for its counsel, Cahill Gordon.

There are three phases to our work, and I think perhaps it's beneficial just to set them out geographically so you'll understand what we've done over the period of time. Initially we did two brief engagements from June 1 to about July 8 or 10, 1982, a period of about 5 or 6 weeks. They were for Cahill. The second series of engagements were five engagements which were performed for E.F. Hutton between July 1982 and August 1984, about 2 years and 1 month. And then there was a third series, from August 1984, that continued through the date of the plea that was, again, for Cahill, Gordon, in the nature of litigation support services.

From the initial engagement by Cahill Gordon in June 1982, through our performance of the five engagements directly for Hutton, that is from August—that is from June 1982 through August 1984, Arthur Young was not involved in investigating the facts under investigation by the Department of Justice or the types of abusive transactions ultimately described in the Department of Justice's information.

During that period, from June 1982 through August 1984, Arthur Young reviewed cash management procedures to be put into effect after June 1982, and made recommendations to improve Hutton's cash management activities and its operations. Arthur Young was not told anything during this period about the facts and/or the specific cash management transactions under investigation, or the fact that there was a criminal investigation. We never served as auditors to E.F. Hutton. We never conducted an audit of Hutton. We never conducted an audit of Hutton's internal controls or their cash mobilization activities. Audit independence was not even an issue with regard to the services rendered by Arthur Young to Hutton. We were not retained to do audits, we didn't do audits. Mr. Goodwin, myself, Mr. Renshaw and Mr. Beehler—none of us are CPA's.

Beginning in August 1984, through the end of 1984, Arthur Young again did some work for Cahill. We performed typical litigation support services for Cahill Gordon, beginning in August 1984. We were retained by Cahill Gordon, and the work we did was subject to the attorney-client work-product privilege, and the attorney work-product doctrine.

First, Mr. Renshaw and Mr. Beehler on my left, provided expert consultation to Cahill Gordon and Mr. Renshaw will describe that very shortly. During these expert consultations, neither Mr. Beehler nor Mr. Renshaw independently investigated the underlying facts or transactions for pre-1982 or post-1982. Nor were they retained to do so.

Beginning in January or February 1985, again for counsel as litigation support assistance, Arthur Young was asked to look at a limited number of transactions relating to the pre-1982 period under investigation. This work was directed by Mr. Goodwin on my right, and he will describe what he did in a brief fashion after Mr. Renshaw speaks. We believe that counsel frequently used experts to assist them in assisting their clients with regard to specialized or archane matters. I understand that each of the members of the subcommittee is an attorney and probably can well understand that there may be times when matters are particuarly specialized or archane, where effective representation might even be denied a client without the assistance of such expert assistance.

To date, Arthur Young has searched and found no prescription, no ruling, no law, no pronouncement, no denouncement which in any way prohibits or constrains corporations which are under criminal investigation from availing themselves of such assistance. In fact, it is our understanding that the Department of Justice and this committee themselves have such expert assistance to explain these rather archane matters. It seems entirely appropriate for a firm of certified public accountants to provide support to the legal profession when it falls squarely within the scope of that firm's accounting practice.

We want to clarify one final issue, and we hope that our detailed statement which we have presented to the subcommittee has done so, as well as the attachments we have attached to it.

There were some reports during July 1985 that Arthur Young had told Hutton to overdraw its bank accounts, or that Arthur Young had told Hutton not to tell its banks about its drawdown processes. We trust that our work papers, which have become a part of the public record since Judge Bell's report, demonstrate that those reports in July were false. Unfortunately, prior to that time, we were not able to fully explain that because, until the release of that information and the publication of our work papers, it was subject to the attorney-client privilege and the attorney work-product doctrine.

Mr. Chairman, with your permission, Mr. Renshaw will now give his brief statement.

Mr. **Hughes**. That'd be fine. Thank you very much.

Mr. **Renshaw**. Mr. Chairman and committee members, I'd like to thank you for the opportunity of speaking with you today, and would like to make a brief statement concerning my role in consulting assistance to E.F. Hutton.

From June 1982 until the spring of 1985, I acted as either project manager or technical adviser on six consulting engagements to either Cahill, Gordon & Reindel or E.F. Hutton concerning cash management and treasury consulting. Our assistance began when we were retained by Cahill, Gordon & Reindel in June 1982. We performed two consulting assignments for Cahill from June through July 1982. Our first assignment was to perform a seminar on cash management for several lawyers at Cahill. Our second assignment was to review a drawdown sheet cash management procedure for Cahill's client, E.F. Hutton. We agreed to review the drawdown sheet to determine the reasonableness and consistency of the proposed procedures with industry practices. We presented our findings to lawyers and to Hutton representatives. We found the drawdown sheet to be both reasonable and acceptable under certain conditions.

We also told Cahill Gordon and E.F. Hutton about some concerns we had about certain cash management practices that were occurring in the industry at that particular time. The advice we gave was not legal advice. Rather, it represented business judgment and experience in cash management. It was intended to permit Hutton to smoothly facilitate its relationships with its banks, manage its cash, and compensate its banks fairly and in a timely manner.

At no time in the course of these meetings did Cahill Gordon or Hutton reveal the existence of the Department of Justice criminal investigation, the types of transactions under investigation, or Hutton's pre-June cash mobilization system.

At that time we were not retained to examine or investigate or consult with respect to any of these subjects. This project included our direct work for Cahill. Between August 1982 and August 1984, we performed five consulting engagements directly for Hutton. We reviewed and evaluated the drawdown procedure, implemented a reverse wire procedure, conducted a review of Hutton's money mobilization department, cash mobilization update, and a caged review. The first four of these engagements listed above related to cash management practices and procedures and were conducted with the direct participation and supervision of myself and another of Arthur Young's cash management consultants, Mr. Paul Beehler.

Arthur Young has already provided the subcommittee with the reports on the first previous engagements, so I'll just briefly describe the results of each of these. We reviewed—the first engagement was to review and evaluate the drawdown procedure. That was August through October 1982. During this review we conduct-

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ed a more detailed analysis of the drawdown worksheets. We prepared reports on the results of tests and analysis, and made recommendations for several improvements.

In the implementation of the reverse wire procedure in October through December we assisted in the implementation of a reverse wire procedure to facilitate funds concentration. We conducted a review of the money mobilization department in December 1982 through November 1983. We reviewed a number of subjects and/or areas relating to Hutton's money mobilization department. We made recommendations to improve Hutton's ability to maintain its banking relationships in the automation of the drawdown process and procedures to centrally manage and control the process.

Finally, we made a cash mobilization update. Between January and February 1984, Arthur Young conducted interviews to check on the efficiency and effectiveness of the drawdown procedure adopted in 1982. It should be emphasized that we did not audit Hutton's use of the drawdown sheet by the four pre-June 1982 or post-June 1982 reviews based upon interviews in the field.

A cage review was performed in June through August 1984. Basically what this was, was an operational review of the Hutton's cage facilities. It did not relate to cash management practices.

In August 1984, we were approached to perform further expert litigation consulting services to assist Cahill Gordon directly in its defense of Hutton. Between August 1984 and May 1985, Mr. Beehler and I were available to provide assistance to Cahill Gordon. Our assistance during that time period consisted of two tasks: Participating in the technical discussions with counsel concerning hypothetical scenarios posed by counsel; preparing a cash management primer for counsel, which counsel submitted to the Department of Justice outlining contemporary cash management practices and the Hutton cash management drawdown sheet.

At this point, my participation in these engagements ceased. I want to reiterate what Mr. Ostling has said of our desire to cooperate with this subcommittee and explain our role, and after Mr. Goodwin makes his statement, I look forward to answering any questions which you may have.

Mr. HUGHES. Thank you, Mr. Renshaw.

Mr. Goodwin.

Mr. GOODWIN. Thank you, Mr. Chairman, Congressmen. I wish to thank you for the opportunity to appear here today.

Between February 1985 and August 1985, I and Arthur Young consultants operating under my direction performed extensive confidential litigation support services for Cahill Gordon on behalf of its client, E.F. Hutton. These services included fact analyses and modelling concerning certain Hutton bank accounts identified by counsel for analysis.

On February 19, 1985, Paul Beehler and I met with Cahill to review the progress of the Justice Department investigation, and to discuss Cahill's anticipated needs for litigation support services involving the development of detailed financial models and analyses of specific bank account analyses—specific bank accounts.

On February 26, in a meeting between Cahill attorneys and myself, it was agreed that I would take control of our consulting services in these areas. This included the completion of two chain analyses which had been initiated by Beehler earlier.

Essentially, in the course of this litigation support assistance, we analyzed four bank chains used by Hutton in concentrating funds, as well as other banking relationships identified by Cahill Gordon. We also provided a variety of services in conjunction with Hutton's development of a model for bank restitution in accordance with its plea with the Justice Department. The objective of our analyses of banking relationships was to estimate average daily collected fund balances for the accounts in question during specific periods identified by counsel. These estimates were prepared by reviewing bank statements, analyzing the sources of checks deposited into these accounts, based on Hutton records, and applying general assumptions about the amounts of time required for checks to clear.

The actual depth of analysis varied, depending on the specific needs of counsel. The analyses of the four chains, for example, did not fully address all banks in each chain, and did not incorporate an evaluation of assumptions made on check clearance times. Our analyses of certain other banking relationships involved a more detailed review.

At no point during our analyses were any interviews or operational reviews undertaken to determine how any particular problem might have arisen. Rather, our analyses were restricted to reviews of specific financial records provided to us through counsel. The results of our analyses were provided to Cahill Gordon, typically in the form of several thousand pages of computer printouts. With the exception of one letter, however, no reports were ever prepared. All of the work papers related to these analyses have been made available to the SEC, Judge Bell's investigative team, and this subcommittee.

Mr. Chairman, this concludes our prepared remarks. On behalf of Arthur Young, we wish to thank you for the opportunity to appear before you today. We will be pleased to respond to any questions you may have.

[The statement of Arthur Young & Co. follows:]

ARTHUR YOUNG

STATEMENT OF ARTHUR YOUNG & COMPANY, BY PAUL J. OSTLING, WILLIAM RENSHAW AND JOHN J. GOODWIN, BEFORE THE HOUSE JUDICIARY COMMITTEE'S SUBCOMMITTEE ON CRIME (HON. WILLIAM J. HUGHES PRESIDING) HEARINGS RELATING TO E.F. HUTTON

October 3, 1985

Arthur Young & Company ("AY") is pleased to have been invited by the Subcommittee to give testimony regarding its role as a consultant to Cahill Gordon & Reindel ("Cahill Gordon") and its client E.F. Hutton ("Hutton"). Testifying on behalf of AY are William Renshaw, John J. Goodwin, and Paul J. Ostling. Messrs. Renshaw and Goodwin were directly involved in the performance of AY's services to Hutton while Mr. Ostling acted as a reviewer of certain projects and provided a bridge to Hutton's counsel on certain matters.

We request that this Statement become part of the Subcommittee's permanent record in this matter.

There has been wide coverage about the Hutton cash concentration system and Hutton's guilty plea. Unfortunately, AY's involvement with Hutton has not been accurately portrayed in this coverage. Misstatement and misconceptions about AY's role have abounded. We thus welcome the opportunity to set the record straight and to answer any questions the Subcommittee may have.

Aside from our own interest in clearing the air, we have been encouraged by Hutton, by Cahill Gordon, and by Hutton's special counsel O'Melveny & Myers to work with the Subcommittee staff prior to today and to testify. Hutton has waived its attorney-client privilege relating to the matters covered in our written testimony today and to the documents which the Subcommittee might wish to review. Similarly, Cahill Gordon has waived the attorney work product doctrine with respect to these same matters.

This Statement is intended to address the following subjects:

- Who retained AY, to do what, and when;
- What type of services and advice AY rendered and gave;
- Whether the drawdown process in operation at Hutton after June, 1982 is consistent with industry practice;
- What professional guidelines and rules of practice pertained to the services rendered by AY; and
- When anyone from AY first obtained knowledge of, or became involved in, reviewing any of the background or details of the practices which were ultimately described in the Department Of Justice ("DoJ") Information against Hutton.

I. EXECUTIVE SUMMARY

AY's engagements with respect to cash management at the start were for Hutton's counsel, and were part of what we broadly call "litigation support" services. All of our engagements for Cahill Gordon were designed to assist counsel in providing legal services to its client.

AY was retained by Cahill Gordon in June, 1982 -- after the DoJ's investigation had commenced, and after the time period in which Hutton has said it ceased the practices described in the Information against Hutton. However, when AY was retained, it was not informed of the existence of the criminal investigation or the types of cash management abuses which were being investigated. All AY knew initially was that counsel was retaining AY to assist in legal representation of Hutton.

Prior to its retention by Cahill Gordon in June, 1982, AY never performed any consulting services for Hutton in connection with cash management or the areas which this committee is investigating.

From the time of its initial performance of two engagements for Cahill (June 1, 1982 through July 8, 1982), through its performance of several cash management engagements and one brokerage engagement for Hutton (August 23, 1982 through August, 1984), AY and its consultants were not involved in any way in investigating the facts pertaining to the DoJ's investigation or the abusive transactions which were ultimately described in the Information. From June, 1982 until August, 1984, AY reviewed the cash management procedures to be put into effect after June, 1982, and to make recommendations to improve Hutton's cash mobilization activities and operations. AY was not told anything during this period about the facts and/or cash management transactions which were under investigation.

AY never served as Hutton's auditor. It never conducted an audit of Hutton or Hutton's internal controls or cash mobilization activities. It was never asked or instructed to do so. The issue of audit independence was not relevant to AY's role with Hutton or its counsel.

Beginning in August, 1984, through the date of Hutton's guilty plea AY performed typical litigation support services for Cahill Gordon. Two of AY's cash management experts provided expert consultation to Cahill. They provided:

- answers to hypotheticals posed by counsel,
- advice on cash management practices relating to matters identified by counsel, and,
- a textual discussion of contemporary cash management practices and the Hutton cash mobilization drawdown sheet, including two drawdown sheets utilized by Hutton prior to 1982 (which was submitted to the DoJ by Cahill Gordon in November, 1984).

During this process AY's cash management experts did not independently investigate the underlying facts or transactions relating to the DoJ's allegations, nor were they retained to do so.

Beginning in February, 1985, AY, for the first time was asked to look at a limited number of transactions relating to the pre-1982 period under investigation. We then began a process of detailed fact analysis and extensive computer model and database building on certain specified transactions in bank accounts identified by Cahill Gordon to allow it to analyze four Hutton drawdown "chains" and other specific banking relationships. This work for counsel, which entailed review of bank records, continued after the Hutton plea.

Counsel in civil and criminal matters frequently use "experts" with respect to specialized or "arcane" matters. In some cases the effective representation by counsel is largely dependent on such expert assistance. AY has found no rule, guideline, or prohibition which holds that counsel for corporations under criminal investigation are not permitted to avail themselves of such assistance. It seems appropriate for firms of certified public accountants to provide support to the legal profession when it falls squarely within the scope of their accounting practice.

The final issue which AY will clarify relates to what AY told Hutton with respect to whether banks should be made aware of the Hutton drawdown process and whether Hutton should ever draw down its bank accounts to negative bank ledger balances ("overdraw").

We trust (as Judge Bell noted in his report) that it is now a matter of public record that AY recommended that it was good business practice, although not necessarily legally required, for Hutton to advise its banks about its drawdown process, and that it was inappropriate to draw accounts down to negative bank ledger balances. In making these recommendations AY was not rendering legal advice, as it was never retained to do so.

From the time of the Hutton plea (May, 1985) until the release of Judge Bell's report (September, 1985), AY was legally and ethically prohibited from responding to the question of what it said on this subject. Its work for Cahill Gordon was entirely cloaked under the mantle of the attorney-client privilege and work product doctrine. All of this work had been done under the auspices of and for Cahill Gordon, Hutton's counsel. Moreover, there was never any indication during AY's work that any of its advice or assistance was being used to plan or conduct a criminal activity.

In such circumstances a firm of certified public accountants not only follows good business practice in not making public disclosures about its work for its clients, but it is ethically restricted from doing so without client consent. Had AY attempted to correct the record, its license to do business and that of certain of its partners could have been promptly suspended for improper disclosure of client confidences.

II. ACCEPTABLE CASH MANAGEMENT PRACTICES

Cash management is neither sinister nor illegal. It is a practice which the banks in this country support and from which they derive revenues. In fact, the practice could not even exist unless there was something in it for the banks. Almost every major bank in the country provides cash management services for its clients.

Cash management as a practice by corporations and other institutions has been in existence for many years. As early as 1947, RCA Corporation, in conjunction with two of its banks, developed a cash management service to receive mail and provide faster availability of funds and thus manage the working capital of the company more effectively. While cash management applications vary by company, the objectives of cash management are consistent among users and include:

- Providing for short-term liquidity.
- Operating the organization on a minimum of idle cash.
- Effectively managing the bank relationship to provide the company's banks with fair compensation for services provided, but to avoid over-compensating the banks.
- Effectively using cash to reduce borrowing expenses or generate investment income.
- Efficiently operating the cash management program at minimal cost.

Over the years the use of cash management services and development and implementation of cash management programs have expanded dramatically throughout the United States economy. New and innovative techniques and electronic services are continually being developed and marketed by the service providers (primarily the banks) in the United States and internationally.

Cash management is a well-defined business discipline which is moving toward professional recognition in the United States. As a body of knowledge, cash management is supported and expanded by numerous books, publications, and regularly conducted seminars, which include:

- Textbooks
- Primers (One published by the association of government accountants)
- Two periodicals (Cash Flow Magazine and The Journal of Cash Management)
- Numerous articles appearing in business journals
- Several newsletters published by banks and organizations and private publishers
- A national corporate cash managers association (NCCMA), with over 1,700 members
- Approximately 39 local cash management groups
- Seminars conducted by groups such as:
  - American Management Association
  - Professional development institute
  - Several banks
- A professional certification program now under development

In its inception, cash management was seen as a benefit only to large corporations with significant dollar flows. This view has changed substantially over the last ten years, due primarily to the long-term rise in interest rates and the increasing availability of cash management services. The current users of cash management services today include three major categories:

- Corporations. Large corporations -- that is, the largest business and financial companies in the United States -- have long used cash management services and have in fact generally established separate cash management departments, employing full time cash managers to manage the funds flow throughout the company. These companies represented the first market segment to be actively involved in using cash management services. In the last five years there has been a substantial expansion in corporate use of cash management to mid-sized companies -- i.e., those with sales in the range of $20 million to $100 million per year. The services offered by providers of cash management systems have been increasingly directed toward penetrating this mid-corporate marketplace.

- Governments and government agencies. Cash management as a discipline has been implemented in a number of state, local, and federal government areas. Many state governments, including Texas, Utah, and Pennsylvania, have conducted cash management studies and implemented cash management practices. Additionally, the United States Treasury Department has full time personnel involved in development of cash management service applications and control of funds flow within the government.
- Banks/financial institutions. Banks have long practiced cash management in terms of managing their daily funds position. In addition, sale of cash management services has become an important line of business for banks. Thus, banks use cash management services not only to manage their own funds but also to generate fee income.

Banks, such as Bank of America, Citibank, Morgan, and many others, provide a full range of defined cash management services to their corporate customers. Other financial institutions participating significantly in cash management include the brokerage industry, mortgage banking companies, and savings and loan association associations.

For years banks have been managing cash and earning interest income by taking advantage of the float and not crediting good funds to their customers accounts at the time the funds were fully collected. Banks still take advantage of the float in this manner in the accounts of their individual account holders. As corporate clients have become aware of the time availability of collected funds -- which are their funds -- they have sought to utilize the earning potential on those funds. And now banks are earning significant revenue by offering cash management support services.

The specific techniques and services used in the management of cash by corporations and other users have been developed to support the basic functions which cash managers perform daily in meeting their cash management objectives. Banks and other service providers have developed cash management services to assist cash managers in the basic functions of:

- Collections
- Funds concentration
- Disbursements
- Bank balance management
- Investment and debt management

Banks represent the major suppliers of cash management services today. The specific services offered include:

Functional area	Services
Collections	• Lock-boxes • Checking accounts • Pre-authorized checks • Electronic funds transfer services • Published availabilities
Concentration	• Depository transfer checks • Interbranch deposits • Wire transfers
Disbursement	• Zero balance accounts • Controlled disbursements • Electronic funds transfer services

Bank balance management	• Cash management information services for daily balance information • Terminal based same day transaction information • Account analysis services • Target bank balance reports • Other special services
Investments	• Investment reports • Current market rate reports
Other functions	• Account reconcilment • International reporting • Lines of credit borrowing reports

Although cash management services were initially offered by banks as credit support services, their importance has shifted over the last several years. Today banks look at cash management services as significant revenue-producing services. For this reason, among others, many banks have developed sophisticated internal systems to track deposit float and the volume of services used by their corporate customers. Cash management services are provided by large and small banks alike. Their objectives are to tie in the broader corporate relationship and to generate a profit from cash management services offered.

The expansion and use of cash management services has encouraged specialized vendors to enter this lucrative marketplace. The companies involved in offering specialized cash management services include:

- IBM
- Automatic Data Processing
- National Data Corporation

- General Electric
- First Data Resources

An objective of many of the services offered and the focus of activity for cash managers is the efficient daily management of float. Float management is one of the objectives of all cash management systems. Float is not one element, but a number of elements which occur at different points in the business cycle of the company. Generally, float can be defined as "cash in the process of collection." From a cash manager's viewpoint, the banking system has float inherently imbedded in it because of the structure of the United States payment system. Bank float is usually viewed as:

- Collection float -- checks deposited with banks must complete a clearing process that usually takes zero, one, or more business days before the checks are collected and made available to the depositor without restriction.
- Disbursement float -- checks issued in payment of corporate obligations will not result in an immediate debit to the corporation's checking account but must first be (1) received by the vendor or obligee, (2) deposited for clearing in the recipient's bank, and (3) presented for payment through the interbank clearing system. Until step (3) actually occurs the cash manager of the corporation issuing the check still has use of the funds.

Float tracking is an important consideration in any cash management program. Float studies are regularly conducted by banks and by independent organizations to quantify the time it takes for checks to clear the United States banking system. This information is used by banks in determining the effectiveness of their funds collection services and by cash managers in deciding which banks to use for collections and disbursements.

The cash management practices of thousands of American companies work precisely because the banks make them work and the banks derive revenues from them.

Although the practices of Hutton described in the DoJ's Information can be considered an abuse of good industry practices, the "drawdown" process which AY reviewed between June and October, 1982, was neither unusual nor overreaching. If that drawdown process had been followed before May, 1982, there probably would have been no DoJ investigation and no significant Congressional interest. In fact, if the drawdown process we reviewed had been used appropriately by E.F. Hutton's branches, there should be no overdrafts, and no abusive drawdowns.

It was not the Hutton drawdown system we reviewed which led to Hutton's problems. To the contrary, it was the avoidance and abrogation of the drawdown sheet described in our reports (which we previously have made available to the Subcommittee), and the use of other practices, which avoided the intent and purpose of the system which led to the problems. This was a people problem; it was not a "systems" problem. We will be glad to elaborate on the specifics of the report which we just referred to if the committee so desires.

Simply because there was an abuse of cash management practices for a period by a company like Hutton, however, does not mean that every entity which practices cash management is guilty of excessive drawdowns. Likewise, professionals such as AY which attempted to assist Hutton to improve its practices are not guilty of any unethical behavior "by association". The aim of cash management is to fairly compensate a bank for its services, and not to overcompensate the bank. In the final analysis it is a company's obligation to maintain an open and communicative relationship with its banks, and it is ultimately the bank's obligation to be sure it has been fairly compensated for its services.

It would be just as serious a mistake to lose sight of the manner in which our banking system works as it would to ignore anyone's violation of the law.

III. OUR INTRODUCTION TO CAHILL GORDON

During May, 1982, Thomas Kavaler of Cahill Gordon telephoned John Giudice (a principal in AY's New York Office Brokerage and Investment Banking Group). He told him he had seen a brochure relating to AY's Brokerage Industry and Cash Management Consulting Program and was interested in discussing AY's background in cash management and the brokerage industry. Giudice met with Kavaler to describe AY's qualifications. On June 1, 1982, Cahill Gordon retained AY to provide Cahill with "background on the state of the art cash management practices in the brokerage industry." See Appendix A

AY is known as having extensive skill and expertise in the subject of cash management. Prior to joining AY, its cash management experts had extensive industry experience working in the banking system. They have authored books and monographs and instructed at numerous seminars, conferences and presentations. They have been called upon to review complex systems and to advise numerous large corporations. They are recognized leaders in the industry. We believe they are equally well known for their honesty and professional integrity. All these things considered, it was neither unusual for nor surprising to AY that Cahill Gordon contacted and then retained AY in June of 1982.

In meeting with and interviewing AY, Cahill Gordon did not:

- Identify Hutton to AY;
- Provide any details of the criminal investigation relating to Hutton; or
- State that such a criminal investigation was ongoing.

Kavaler also had a telephone conversation in early June, 1982, with Paul Ostling, an AY Associate General Counsel whom Kavaler knew well, to stress the confidentiality of AY's work for Cahill Gordon. In addition, many other AY personnel were familiar with Cahill Gordon. The firm is well-known and reputable. The attorney making the contact had a reputation for particular litigation expertise and unquestioned integrity.

Ostling worked with all AY teams working on Hutton matters from June, 1982 through the present. He provided a bridge to counsel and reviewed AY's reports and correspondence.

The AY team assembled to head the initial engagement was comprised of Giudice, Bill Renshaw, AY's Cash Management Product Manager, and Stu Fleischer, an AY Litigation Support Services partner. AY's initial engagement was to put on "one or two workshop sessions" for "approximately four" Cahill Gordon attorneys.

This was not an audit engagement. From the start, AY viewed this engagement as a "litigation support" engagement to assist counsel in representing its client. Initially our client was Cahill Gordon, not Hutton. We reported to them and focused our responses towards them. AY understood that it had been screened by Cahill Gordon to determine its expertise in the cash management field and engaged to provide Cahill Gordon attorneys with specialized information not readily attainable elsewhere.

There was no question of "independence" as that term is defined by relevant AICPA professional guidelines. Because of AY's commitment to the independence of its audit practice and the integrity of all of its consulting services, we were deeply distressed by press reports on July 18, 1985, which questioned our "independence" in performing engagements for Hutton. We wrote to the Subcommittee asking about these matters. See Appendix B. We were quite pleased that this Subcommittee's eminent Chief Counsel, Hayden Gregory, noted to us in his letter of August 5, 1985, that "there was no need for Arthur Young to be independent in this matter, since the firm was not serving as Hutton's auditor" (see Appendix C) and that Professor Abraham Briloff, a professional consultant to the Subcommittee, concurred in this view.

The courts in our country have long acknowledged that counsel and their clients are entitled to retain expert advice to assist and/or to provide expert testimony with regard to arcane or specialized subject matters.

> "Accounting concepts are a foreign language to some lawyers in almost all cases, and to almost all lawyers in some cases. . . . [T]he presence of the accountant is necessary, or at least highly useful, for the effective consultation between the clients and the lawyer."

United States v. Kovel, 296 F.2d 918, 922 (2d. Cir. 1961). Accord United States v. Alvarez 519 F.2d 1036 (3rd Cir. 1975); United States v. Judson, 322 F.2d 460, 462-63 (9th Cir. 1963). Other courts have interpreted the attorney-client privilege as applying to communications with an accountant whenever counsel concludes that his effectiveness calls for that consultation. See, e.g., United States v. Cote, 456 F.2d 142, 144 (8th Cir. 1972) (the "test is whether the accountant's services are a necessary aid to the rendering of effective legal services to the client"); In re J.K. Lasser & Co., 448 F. Supp. 103, 106

(E.D.N.Y. 1978) (privilege attaches when "the accountant's role was to facilitate an accurate and complete consultation between the client an the attorney . . . ."); Bauer v. Orser, 258 F. Supp. 338, 342 (D.N.D. 1966) (privilege attached where accountant's role was "to perform certain specialized and expert services which [the attorney] was not qualified to perform and which were essential in order that [the attorney] give the proper legal advice and render proper legal service to his clients"). In FTC v. TRW, Inc., 628 F.2d 207, 212 (D.C. Cir. 1980), the Court of Appeals for the District of Columbia discussed those cases and stated: "We believe these holdings to be correct and necessary to preserve the effectiveness of counsel in our legal system."

As the Supreme Court has repeatedly held, defendants in criminal investigations are entitled to effective representation of counsel. Evitts v. Lucey, 105 S.Ct. 830, 53 U.S.L.W. 4101 (1985). Depriving defense counsel of the right to expert witnesses where the subject matter of a criminal investigation is one of legal first impression, and one so steeped in the specialized area of the banking system and cash management, would be a denial of effective representation by counsel. Whether it be a Congressional committee or a company with a problem, outside knowledge and assistance are often both necessary and justified.

We therefore reiterate that we have searched the applicable professional guidelines of the accounting and legal professions. We are unable to find any rule, pronouncement, denouncement, warning, or criticism suggesting that a firm of certified public accountants should not act as counsel's expert or counsel's client's consultant where the subject matter is clearly within the scope of services of the accounting firm.

IV. CONDUCT OF THE FIRST ENGAGEMENTS

When Giudice, Renshaw, and Fleischer met with Kavaler and two other Cahill Gordon attorneys on June 7, 1982 to discuss cash management in the brokerage industry and to answer technical questions the lawyers posed, we knew nothing of the existence of the DoJ investigation or the transactions being investigated. It was only after the meeting that Kavaler identified Hutton as Cahill's client and arranged to introduce AY to Hutton at another meeting to be held on June 11, 1982.

At the June 11 meeting, AY was told about the proposed drawdown sheet cash management procedure which Hutton wanted to institute as soon as Hutton's legal and technical personnel approved the drawdown sheet process. The parties discussed the proposed worksheet to be instituted and how Cahill Gordon wanted AY to conduct a prompt, limited review of the drawdown worksheet, and comment upon its reasonableness and consistency with industry practice. It was decided that AY would undertake that engagement. An engagement letter, dated June 17, 1982, (Appendix D) described precisely what AY would do.

At no time in the course of these meetings did Cahill Gordon or Hutton reveal the existence of the DoJ criminal investigation, the types of transactions under investigation, or Hutton's pre-June, 1982 cash mobilization system. At that time, AY was not retained to examine, investigate, or consult with respect to any of those subjects. Rather, AY's engagements focused on the prospective drawdown system which was to be implemented by Hutton after June, 1982, after approval from a technical and legal standpoint.

On June 23, 1982, AY consultants met with representatives of Cahill Gordon to explain the AY approach to and the preliminary results of the second engagement. With respect to the reasonableness and acceptability of the new drawdown procedure AY advised that:

"1. Reasonableness

"The procedure to be implemented appears reasonable in approach requiring certain conditions.

- The proposed worksheet at the branch level allows for:
    - Moving toward a negative collected balance position to hit target balances.
    - Avoiding negative bank ledger balances.
- This approach is reasonable given the following conditions.
    - The target balance should be agreed upon by the bank as an adequate level of compensation.
    - The bank should be aware of the practice and agree to the approach.

"2. Acceptability

"Moving toward a negative collected balance position to hit a target balance is the key area of acceptability.

- In our experience such a practice was in concert with generally accepted practices.
- Our limited sample showed to that date that it was a cash management practice used by other brokers.
- It was reasonable if the approach was being used to reach a fair compensation level with the bank."[*]

AY also told Cahill Gordon about some concerns it had about certain cash management practices and the manner in which the Hutton drawdown sheet should be implemented. The advice given by AY was not "legal advice". Rather, it represented sound business judgment, and was intended to permit Hutton to smoothly facilitate its relationship with its banks, manage its cash fairly and ethically, and compensate its banks fairly and in a timely manner.

On June 28, 1982, another meeting was held to discuss the results of the AY review relating to reasonableness and acceptability. Hutton representatives Thomas Rae, Norman Epstein, and Loren Schecter were in attendance. The same advice delivered on June 23 concerning reasonableness and acceptability of the proposed drawdown process was repeated, as were AY's concerns and related comments.

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[*] Judge Griffin Bell included as Exhibits to his report a copy of a June 28, 1982 memorandum from Renshaw to Ostling noting AY's advice, as well as a letter from AY to Cahill Gordon dated July 28, 1982 which contained copies of the outlines AY used in the June 23, June 28 and July 8 meetings to present its conclusions. (footnote cont'd)

On July 8, 1982, AY consultants met with representatives of Hutton and Cahill Gordon to discuss the results of AY's review relating to the efficiency of the proposed drawdown system. From a business standpoint, AY had some concerns about the efficiency of the drawdown system, branch personnel's competence to handle it, and suggestions to improve efficiency. AY consultants explained that the review and advice it had given to that point in time had been based on interviews and descriptions without a review of Hutton's operating procedures. AY suggested that to be more definitive, its review would have to be more detailed and include a review of the drawdown sheet in operation. It was agreed that AY would conduct such a more detailed review.

At the conclusion of the July 8 meeting Kavaler of Cahill Gordon told the AY consultants that they could work directly for Hutton on future engagements until instructed otherwise by Hutton's counsel. AY was not so otherwise instructed until more than two years later during the second half of 1984.

During the course of these initial two Cahill Gordon engagements AY was not given any description of the DoJ investigation or the kinds of transactions (abusive drawdowns and chaining) being investigated. Not a single AY consultant has a recollection that he or she was told or heard that there even was

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These documents, which have been previously provided to the Subcommittee, are attached as Appendix E.

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such an investigation. At this time AY was not asked to perform any evaluation, study or analysis of the drawdown sheet or the cash management practices utilized at Hutton prior to June 1, 1982.

On July 28, 1982 AY provided Cahill Gordon with a letter and presentation outlines describing and memorializing the results and advice from the AY engagements. See Appendix F.

V. ENGAGEMENTS FOR HUTTON

Between August, 1982 and August, 1984, AY performed five engagements for Hutton:

1. **Review and evaluate the drawdown procedure** -- August 23 through October 4, 1982.
2. **Implement reverse wire procedure** -- October 14 through December 7, 1982.
3. **Conduct review of Hutton's Money Mobilization Department** -- December 3, 1982 through November 21, 1983.
4. **Cash mobilization update** -- January, 1984 through February, 1984.
5. **Cage review** -- June 15 through August, 1984.

The first four of the engagements listed above related to cash management practices and procedures, and were conducted with the direct participation and supervision of Bill Renshaw and another of AY's cash management experts, Paul Beehler. Neither Mr. Fleischer nor Mr. Giudice was involved in those engagements.

A. Review and Evaluate Drawdown Procedure

AY has already provided the Subcommittee with the reports, dated September 20 and October 4, 1982, it produced during this engagement. Pursuant to this engagement AY obtained drawdown worksheets from 25 Hutton branches, randomly selected, for the period after June, 1982, which utilized the proposed drawdown procedure. The branches utilized the drawdown sheet for a two-week period, and AY received the sheets and analyzed the data to determine the efficiency and effectiveness of the drawdown procedure.

AY utilized a microcomputer and performed virtually hundreds of test transactions to test the drawdown process. The tests demonstrated that if the directions of the drawdown sheet were followed, it could be utilized to effectively manage cash to take advantage of the float without overdrawing accounts or creating negative bank ledger balances. Although the AY consultants were not acting as lawyers, they believed the drawdown sheet process would be entirely legal. In hindsight, not only is the drawdown sheet now in use legal, if it had been followed by Hutton's branches in periods prior to our involvement, none of the excessive drawdowns described in the DoJ's Information should have occurred. It resulted in average collected balances sufficient to cover checks drawn on Hutton's bank accounts (so there would be no overdrafts) and compensated the banks for their services.

AY prepared reports of the results of its tests and analyses and made recommendations for several improvements. It also recommended the adoption by Hutton of a Friday reverse wire procedure to more efficiently transfer and concentrate funds.

B. Implement Reverse Wire Procedure

AY has already provided the Subcommittee with the reports, dated November 16 and December 7, 1982, it produced during this engagement. Pursuant to this engagement AY developed a check list and criteria to evaluate banks' capabilities to perform reverse wire services and conducted interviews of banks' personnel to determine the banks' ability to provide reverse wire services. A check list was completed for each bank interviewed, and AY personnel worked with Hutton personnel to select the banks to be chosen to provide services. AY assisted Hutton with the implementation of the reverse wire procedure.

C. Conduct Review of Money Mobilization Department

AY has already provided the Subcommittee with the final report it produced during this engagement, dated November 21, 1983. Pursuant to this engagement AY reviewed the following subjects and/or areas relating to Hutton's Money Mobilization Department:

- Bank Compensation
- Bank Architecture
- Treasury Reporting and Information Flows
- Treasury Organization Structure
- Bank Costs
- Money Mobilization Policies and Procedures

- Internal Float considerations, such as:
  - Coupon Clipping
  - Bond Redemptions
  - Commodities (margin calls and investment opportunities)
  - Check Receipt and Processing

During the performance of the engagement AY consultants conducted project status meetings with Hutton to discuss the scope and findings of the engagement. An interim report was delivered on July 13, 1983. Since the Subcommittee has the final report, AY will not lengthen this statement by describing all of the recommendations and findings included in it. Suffice it to say that AY recommended the establishment of a treasury function at Hutton to improve Hutton's ability to maintain its banking relationships, and the automation of the drawdown procedures to centrally manage and control the process. We believe that AY's recommendations have in many respects either been adopted by Hutton or recommended for adoption in Judge Bell's report.

D. Cash Mobilization Update

Between January and February, 1984, AY conducted interviews to check on the efficiency and effectiveness of the drawdown procedure adopted in 1982, with respect to use of the drawdown sheet in selected regions for approximately a three week period in January, 1984. The results of this review demonstrated that where the instructions on the drawdown sheet were followed Hutton was not creating overdraft situations (with the exception of isolated instances where mathematical or other errors were apparently made by those responsible for filling out the drawdown sheets).

AY did not "audit" Hutton's use of the drawdown sheet either for pre-June, 1982 or post-June, 1982. AY did not audit or review "chaining", "excessive" drawdown, or criss-cross transactions. AY did not know, nor was there any compelling need for AY to know, that those transactions were an issue or were being investigated until late 1984 because such past transactions were irrelevant to the work AY was then doing.

At the conclusion of its update review, AY made an oral presentation to Hutton and its counsel. No written report was prepared for delivery as a result of this engagement.

E. Cage Review

During this engagement, AY conducted an operational review of Hutton's "Cage" facilities which are centered in New York. The subjects covered in the engagement included stock loans, stock transfer, and stock records. The engagement did not relate to cash management practices, and it was performed under the direction of Giudice. A final report prepared as a result of this engagement was delivered to Hutton during September, 1984.

F. Lack of Involvement in The Criminal Investigation

During the completion of the five engagements described above in sections IV.A through E, *supra*, AY was not given details about the DoJ investigation. Indeed, during the period July, 1982 to August, 1983, AY was not aware that a criminal investigation was active. AY was not engaged to investigate or analyze any of the allegations being made or subjects being looked into by the DoJ. AY was not aware of or asked to investigate or review the actual transactions or the types of transactions which were the subject of the DoJ investigation. AY was not engaged to, nor did it, conduct any audit or widescale review of Hutton's cash management transactions for either the period prior to May, 1982 (the period under DoJ investigation) or the period after July, 1982 (the period during which the "new" or "proposed" drawdown procedures were being implemented and utilized).

VI. ENGAGEMENTS FOR CAHILL GORDON IN 1984 AND 1985

It was not until August, 1984 that AY was approached to perform further services to assist Cahill Gordon directly in its defense of Hutton. Renshaw and Beebler (who were not working on the Cage Review) were then asked to be prepared to participate and to participate in discussions with Cahill Gordon relating to cash management.

During 1985, AY consultants also became involved in providing additional litigation support services to Cahill Gordon relating to detailed factual analyses of account transactions. In no case did AY's activities in performing these services for Cahill Gordon render AY in a conflict of interest position with respect to the services it had earlier rendered for Cahill Gordon or Hutton.

A. Renshaw and Beebler Expert Assistance

Between August, 1984 and May, 1985 AY's cash management experts Renshaw and Beebler were available to provide assistance to Cahill Gordon. Their assistance during that time period consisted of two tasks:

- Participate in technical discussions with counsel concerning hypothetical scenarios posed by counsel relating to drawdowns, chaining, swaps, multiple drawdowns, and related money mobilization issues; and,
- Prepare a "cash management primer" for counsel, which counsel submitted to the DoJ, outlining contemporary cash management practices and the Hutton cash management drawdown sheet. The report described two drawdown sheets utilized by Hutton prior to June, 1982 and explained that, based upon certain tests of the sheets, while one was more aggressive than the other, both were acceptable drawdown techniques (i.e., they did not result in negative bank ledger balances). The "primer" also described certain hypothetical instances in which multiple drawdowns might be acceptable cash management techniques (e.g., as long as they were not being used solely to generate artificial float and collection delays).

It was during this engagement that AY first understood any of the types of allegations which might be being made by the DoJ. Even during this engagement, however, AY was not asked, and thus did not, investigate any internal Hutton documents relating to cash management processes or the details of the transactions under scrutiny by the DoJ. AY was instructed by Cahill Gordon that it would provide AY with all information necessary for its work and AY was not to independently seek information about the scope or nature of the DoJ investigation.

AY was twice subpoenaed by the DoJ during this period -- once in November, 1984, and once in April, 1985. AY was not required to testify, but the cash management primer was turned over to the DoJ by Cahill at some point during November, 1984.

B. Fact Analyses and Model Building

Between February, 1985 and August, 1985, AY consultants under the supervision of John J. Goodwin conducted extensive litigation support services. These took the form of fact analyses and modeling to permit detailed analyses of certain Hutton bank accounts selected by Cahill. On February 19, 1985 Cahill attorney Edward Krugman met with Beebler and Goodwin to discuss the anticipated progress of the DoJ litigation and the need for a type of consulting different from the expert assistance relating to cash management practices -- e.g., detailed litigation support fact analyses and model building.

On February 26, 1985, Cahill Gordon instructed AY to construct a "Chinese wall" so that Beebler and Renshaw would not be involved in the future in the factual analyses support. It was determined that since Cahill Gordon might want to use Beebler and Renshaw as trial expert witnesses it would be better from a litigation strategy perspective that they not be involved with the detailed fact analyses and model building. This is a typical practice used by litigators. They want to isolate their trial experts from the factual development of information. Goodwin therefore took control of these efforts and carried through with the analysis of two "chains" which had been preliminarily begun by Beehler and the much larger effort described below.

Essentially, in the course of this litigation support assistance AY's consultants analyzed banking records relating to four "chains" and other banking relationships identified by Cahill Gordon, as well as providing services in conjunction with Hutton's development of a model for bank restitution. The focus of the work included:

- "Genesee" Chain: New York-Wilkes Barre-Batavia (November/December, 1981);
- "Huntington" Chain: New York-Reading-Huntington (November/December, 1981);
- "Shreveport" Chain: New Orleans-Dallas-Houston (October, 1980-March, 1981);
- "Old Kent" Chain: Detroit-Grand Rapids-Midwest (September, 1981-December, 1981);
- Commonwealth National Bank (1983);
- Bryn Mawr Trust (1982);
- Connecticut banks: including Hartford National Bank (now Connecticut National Bank) and Connecticut Bank & Trust (June, 1980-December, 1982);
- Advice with respect to check-clearing times and bank reserve requirements; and,
- Review of Hutton model for analyzing bank restitution claims.

The objective of AY's analyses of banking relationships was to estimate average daily collected fund balances for periods specified by counsel. These estimates were prepared by reviewing bank statements for the accounts in question, analyzing the sources of checks deposited into these accounts based on Hutton records, and applying general assumptions about the amounts of time required for checks to clear. The actual depth of analysis varied depending on the needs of counsel. The analyses performed with regard to the four "chains" did not fully address all banks in each chain and did not incorporate any evaluation of the reasonability of assumptions made on check clearance times.

AY's analyses were supplied to Cahill with respect to these matters. All of the workpapers relating to these litigation support services by the "Goodwin team" have been made available to the SEC, Judge Bell's investigative team, and this Subcommittee.

C. There Is No Conflict In AY'S Services

Some observers have suggested that there was some "conflict of interest" between AY's role as consultant for Hutton and its role as consultant for Cahill Gordon, or that it was somehow improper for AY to be in a role of alleged "advocate" for Hutton. Certainly, Hutton and its own law firm, Cahill Gordon, appeared to AY at all times between June, 1982 and May, 1985, to have a complete "mutuality of interest" with regard to the subject matter of the DoJ investigation.

AY never intended to become or not to become an "advocate" for Hutton. It never considered that to be an option. AY definitely intended, however, to provide consulting services to Hutton's counsel, who certainly were and are Hutton's advocates. In providing advice to counsel for Hutton, AY used the same quality and professional approach to consulting services as it does for any of its clients.

AY has produced all of its workpapers requested by this Subcommittee, the Securities and Exchange Commission and Griffin Bell.

AY's services (from August, 1984 through August, 1985) in providing expert advice or litigation support services to Cahill Gordon relating to the DoJ's investigation of Hutton cash management activities which allegedly occurred before May, 1982, did not change or undermine the results of the consulting advice or reports rendered earlier by AY with respect to proposed or existing systems, processes, procedures and structures which were reviewed as of and during the period from June, 1982 through August, 1984.

In the period from August, 1984 through the present, AY had clients which needed expert support in connection with ongoing investigations and resulting litigation and management operations problems. AY was not then and is not now aware of any rule or guideline which prohibits firms of certified public accountants from providing advice and assistance to troubled companies. Every person who is charged with a crime in our society is entitled to a presumption of innocence and a competent defense. Presumably the public and the market would hope that financial experts and certified public accountants will always be available to assist companies which are troubled to assess and correct deficiencies which exist.

VI. CONCLUSION

AY did not violate any ethical or legal proscriptions in providing services to Hutton and its counsel. Its services were rendered in the course of clearly delineated, discreet engagements relating to cash management and cash management-related litigation. In rendering these services AY did not encourage Hutton or its counsel to violate any laws, to hide any violations, or to engage in any questionable activities. Indeed, if the drawdown sheet process which AY had reviewed in 1982 had been followed by Hutton without abrogation or exception, the problems besetting Hutton would be considerably less today.

AY conducted no "audits" of Hutton's drawdown process or its cash management system. It never served as Hutton's auditors. AY acted as a consultant to Hutton and as provider of litigation support services to Cahill Gordon. In rendering those services AY observed all ethical and legal guidelines and rules. It had no "conflict of interest", and wishes to stress this point.

Cash management _per se_ is not a crime and it is not inimical to the banking system. The banks themselves manage the float and their cash, running a profitable business providing such cash management services to clients. It is not management of cash _per se_ which should be a concern. Rather, it is the abusive avoidance of legal cash management systems that is a valid area of concern. Even in retrospect, AY's review of Hutton's new drawdown sheet in June, 1982 was quite consistent with that goal.

Finally, AY has done its best to cooperate fully with this Subcommittee, the SEC, and Judge Bell. We have an interest in seeing constructive change emerge from this situation. The public and entire accounting profession will be the better for it.

ARTHUR YOUNG

APPENDICES

A. AY Initial June 1, 1982 Engagement Letter with Cahill Gordon

B. Letter of Paul J. Ostling to Hayden Gregory, dated July 24, 1985.

C. Letter of August 5, 1985 from Hayden Gregory to Paul J. Ostling.

D. Engagement Letter of June 17, 1985.

E. June 28, 1985 memo.

F. Letter of July 28, 1982 to Cahill Gordon.

A

ARTHUR YOUNG

ARTHUR YOUNG & COMPANY
277 PARK AVENUE
NEW YORK, NEW YORK 10172

June 1, 1982

Mr. Thomas J. Kavaler
Cahill Gordon & Reindel
80 Pine Street
New York, N.Y. 10005

Dear Tom:

It was a pleasure meeting with you and your colleagues this past week to discuss Arthur Young's Cash Management Program and brokerage industry experience.

As we discussed, you are representing a brokerage client in litigation related to cash funds mobilization through the external banking systems. You have requested Arthur Young's management consulting experience to provide you with background on the state of the art cash management practices in the brokerage industry.

To meet your requirements, we will conduct one or two workshop sessions at Cahill Gordon & Reindel. We expect approximately four attorneys from your firm to be in attendance at each workshop. Our Arthur Young team will consist of Mr. John Giudice, head of our Brokerage and Investment Banking Group, Mr. William Renshaw, our Cash Management Product Manager, and Mr. Stuart Fleischer, our Litigation Support Representative.

As we discussed, our services will be provided to Cahill Gordon & Reindel on a per diem basis plus out-of-pocket expenses. Our fees are based on the level of experience of each consultant assigned to the project and the actual time spent on the project. We estimate our average hourly rate for our services to be approximately $ for each individual. At this writing, we have incurred approximately $ in fees to prepare for our first meeting scheduled for June 1, 1982.

Should you have any questions or wish to discuss specific points of this letter, please contact Mr. John J. Giudice at (212) 407-1814. We welcome the opportunity to provide our professional services to Cahill Gordon & Reindel and we look forward to working with you and your colleagues.

Very truly yours,

Arthur Young & Company

8

A MEMBER OF ARTHUR YOUNG INTERNATIONAL

ARTHUR YOUNG

277 Park Avenue
New York, New York 10172
Telephone: (212) 407-1500
Telex: TRT-177704

July 24, 1985

Hayden Gregory, Esq.
Chief Counsel
Subcommittee on Crime
U.S. House of Representatives
207 East Cannon Building
Washington, D.C. 20515

Re: E.F. Hutton

Dear Mr. Gregory:

I read the Wall Street Journal article of July 18, 1985, and was surprised to read that your Subcommittee was conducting a "separate investigation" of Arthur Young & Company. This was the very first time we had heard that any committee was involved in such an investigation, and we would have expected to have heard it from some official rather than to read of it in a newspaper. Is this true?

Given the fact that the Subcommittee is utilizing Mr. Briloff as a consultant in the Hutton matter -- and that you had him sit in on our non-public, informal meeting on Saturday, June 8, 1985 -- I was more than a little amazed at, and do not understand the appropriateness of, his making such critical statements about Arthur Young's role as consultants to Hutton and its counsel to anyone outside your Subcommittee, not to mention a reporter from the Wall Street Journal. What is particularly upsetting to us is that you and he knew that we were never Hutton's auditors, that Messrs. Boehler and Renshaw were involved in reviewing the cash management system after the period covered by the Justice Department's investigation, and that no one from Arthur Young suggested that Hutton should continue to utilize the "controversial system" in effect prior to early 1982.

Needless to say we take issue with the statements made in the July 18, 1985, Wall Street Journal article, and want you to be aware that we have been misquoted in that article as well as in an earlier article in the Wall Street Journal. We are very disappointed that a member of your investigative team helped to misportray our role and the advice we gave to Hutton.

Hayden Gregory, Esq.
July 25, 1985
Page 2

Notwithstanding our concerns, as we reiterated during our meeting with you, subject only to the bounds of what we are free to disclose as directed by our clients, we stand ready to cooperate with the Subcommittee.

Very truly yours,

Paul J. Ostling

Paul J. Ostling
Associate General Counsel

C

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U.S. House of Representatives
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Washington, DC 20515
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GENERAL COUNSEL
M. ELAINE MIELKE

STAFF DIRECTOR
GARNER J. CLINE

ASSOCIATE COUNSEL
ALAN F. COFFEY, JR.

August 5, 1985

Paul J. Ostling, Esquire
Associate General Counsel
Arthur Young
277 Park Avenue
New York, New York 10172

Dear Mr. Ostling:

I am writing in response to your letter of July 24 which I received on July 29th. Your letter concerns a Wall Street Journal article on July 18 which implied that the Subcommittee on Crime is conducting a "separate investigation" of Arthur Young's role in advising E.F. Hutton and Company on its cash management practices.

We are not conducting such a "separate investigation". We have not indicated, publicly or privately, to anyone that we are, and we have done nothing and said nothing which forms a reasonable basis for such a conclusion. When asked by reporters, as I have been following the Wall Street Journal article, I have unequivocally answered that we are not conducting an investigation of Arthur Young's role in this matter. What I have indicated is that the Subcommittee is addressing its concerns to Hutton regarding a number of instances in which attorney-client privilege has been advanced as a basis for refusing to produce documents subpoenaed by the Subcommittee, and that one of those instances concerns the consultant services provided to Hutton through, it appears, a contractual relationship with Hutton outside counsel.

Your letter indicates that you were misquoted in the same newspaper report. Given that experience, I am sure you can understand that conclusions that reporters make on their own, without reference to attributed statements, are even more subject to misinterpretation.

Paul J. Ostling, Esquire
Page Two
August 5, 1985

In regard to your concerns about remarks attributed to Professor Briloff, I note that he is not identified in the report as having any affiliation with the Subcommittee. He is, rather, quoted in his capacities of "professor of accounting" and "industry critic". I also note that his comments reported in the Wall Street Journal, like those of a Professor Chatov of SUNY at Buffalo, appear to address the issue of accounting firms also serving in a consultant role in circumstances where that role might be interpreted as one of advocacy. Arthur Young's participation in this respect is a matter of public record.

Nonetheless, I have spoken to Professor Briloff regarding our Committee's policies regarding public comment based on non-public information obtained in the course of a Committee investigation, and he has assured me he has and will observe our policies so far as they may apply to his consultation with the Subcommittee. You may be interested to know that Professor Briloff expressed to me his regret that certain remarks he made to the Wall Street Journal were not also reported in the account. These remarks were to the effect that there was no need for Arthur Young to be independent in this matter, since the firm was not serving as Hutton's auditor.

Thank you for the past cooperation of Arthur Young, and for your expression of willingness to continue to cooperate in the future.

Sincerely,

Hayden Gregory
Counsel
Subcommittee on Crime

HG:ph

cc: Abraham Briloff

D

ARTHUR YOUNG

ARTHUR YOUNG & COMPANY
277 PARK AVENUE
NEW YORK, NEW YORK 10172

June 17, 1982

Mr. Thomas J. Kavaler
Cahill Gordon & Reindel
80 Pine Street
New York, New York 10005

Dear Mr. Kavaler:

Arthur Young & Company is pleased to respond to your request to undertake a review of the cash mobilization system and procedures of a brokerage client you are representing. As we discussed at our meeting with you on June 11, 1982, the objectives of the study will be to review the proposed cash mobilization system and procedures of your brokerage client and determine whether such procedures are reasonable and consistent with existing industry practices.

To satisfy the project objectives, we have divided the project into three major tasks:

- Review current and proposed cash mobilization procedures to determine the reasonableness and consistency of the proposed procedures with industry practices. In addition, we will identify potential improvements to the proposed cash mobilization system.
- Through our experience and knowledge within the industry, we will develop a group of precedents of similar firms utilizing cash mobilization techniques.
- Review the risk factors affecting the proposed procedures which may reduce the benefits of implementing the new procedure.

At the conclusion of our work, we will provide you with an oral presentation of our findings and recommendations.

June 17, 1982
Mr. Thomas Kavaler
Page 2

We have assembled a project team which is both experienced in the functional and technical areas of cash management and possess experience in studies of this nature. Mr. William Renshaw, a manager in our New York office, will act as Arthur Young & Company project manager. Technical support will be provided by Mr. John Giudice, head of our Brokerage and Investment Banking Group and Mr. Paul Beehler, our cash management Technical Advisor for studies of this nature. Mr. William Scherer, a partner in our New York office will be responsible for the total Arthur Young & Company participation.

As we discussed, the study will take one to two weeks to complete. We have expedited the start of this project based upon our telephone conversation with Joel Davidson on June 15, 1982 authorizing us to begin work immediately. We estimate our fees will be approximately $ plus out-of-pocket expenses. Fees for our services will be billed at the conclusion of the project together with out-of-pocket expenses incurred.

We look forward to working with you, and should you have any questions regarding this letter or require further information, please contact Mr. William Scherer at 212-407-1874 or Mr. William Renshaw at 212-407-1873.

Very truly yours,

Arthur Young & Company

ARTHUR YOUNG

C Chip

DATE: 6/25/82

: Paul Ostling
cc: William Scherer

FROM: William Renshaw

SUBJECT: CAHILL GORDON & REINDEL PROGRESS MEETING

On June 23, 1982, Paul Beehler, Chip Steppacher and I met with Tom Kavaler and Joel Davidson of Cahill, Gordon & Reindel to present our conclusions as the reasonableness and acceptability of the new cash mobilization procedures as well as the effectiveness of the new procedures. The meeting was conducted at their request prior to the presentation of conclusions, to their client, EF Hutton. The following is an outline of the presentation given to the attorneys:

A. Arthur Young Approach to the Project & Current Status

As stated in our letter of June 17, 1982 the objectives of our assistance to Cahill Gordon & Reindel have been to review the proposed cash mobilization system and procedures and determine whether such procedures are reasonable and consistent with existing industry practices. Given the urgency that your client has expressed for answers to these questions, we are prepared to comment at this time upon the reasonableness and consistency, but not the effectiveness of the proposed procedure. We have not completed our interviews with other firms and are still in the process of testing potential improvements to the procedure developed by your client. To date the work that has been completed:

1. Two brokerage firms and one retail firm have been interviewed regarding their banking practices.
2. One more firm will be interviewed early next week.
3. Various worksheet scenerios have been run through using conservative estimates and assumptions.

B. Conclusion as to the Reasonableness and Acceptability of the New Procedure

1. Reasonableness

The procedure to be implemented appears reasonable in approach requiring certain conditions.

- The proposed worksheet at the branch level allows for:

38 (5/81)

    - Moving toward a negative collected balance position to hit target balances.

    - Avoiding negative bank ledger balances.

- This approach is reasonable given the following conditions.

    - The target balance should be agreed upon by the bank as an adequate level of compensation.

    - The bank should be aware of the practice and agree to the approach.

2. Acceptability

Moving toward a negative collected balance position to hit a target balance is the key area of acceptability.

- In our experience such a practice is in concert with generally accepted practices.

- Our limited sample shows to date that it is a cash management practice used by other brokers.

- It is reasonable if the approach is being used to reach a fair compensation level with the bank.

C. Comments on the effectiveness and efficiency of the new cash mobilization procedures.

1. We have not completed our analysis of the worksheet, however, the scenerios provided by EFH and those developed by A.Y. show potential overcompensation of the bank. This may be due to the Thursday and Friday adjustments.

The key point in the analysis that is currently being undertaken is that the proposed procedures may be improved to:

- Achieve better cash flow through mobilization
- Streamline the procedure for easier implementation

D. Concerns

1. The usefulness of the procedure will be limited to banks that can provide collected balance information. Smaller banks in certain areas cannot provide this information.

- So long as the bank is not placed in a negative ledger position, the Fed will not be especially concerned. Further, the company must agree to cover negative ledger balances with either Fed funds or establish a credit line. We strongly recommend a written agreement in both cases.

2. Circular DTC's - The objective is incongruent with Feb objectives.

3. "Created" ledger balances - draw on uncollected funds.

E. Future Considerations

1. There are other more efficient and cost effective ways to mobilize funds through the concentration system we would be happy to explore.

In general, the reaction received from the attorneys was favorable and they were anxious to set up a meeting with EF Hutton as soon as possible. Some of the comments made by Tom Kavaler were:

- Norm Epstein will be interested in only the first decision to implement immediately the new procedures country wide. We can express our hesitation about instituting this procedure concurrently at all branches, but it probably won't change his implementation plans.
- We should impress on Norm Epstein the additional efficiencies and potential benefits which could be achieved from modifying the new procedures.

Joel Davidson asked to meet with us at a later date to discuss the precedents of firms we had interviewed.

The meeting to present our conclusions to EF Hutton has been scheduled for June 28, 1982.

W. R.

cc: Paul J. Beehler (San Francisco Office)
John J. Giudice
Chip Steppacher

CONCLUSIONS PRESENTED-JUNE 23, 1982

- THE APPROACH APPEARS REASONABLE GIVEN THE TARGET BALANCE IS AN ADEQUATE LEVEL OF COMPENSATION AND THE BANK AGREES TO THE PRACTICE.

- THE APPROACH IS AN ACCEPTABLE PRACTICE WITHIN THE INDUSTRY.

- WE EXPRESSED CONCERNS THAT:

  - CERTAIN BANKS MAY NOT BE ABLE TO PROVIDE COLLECTED BALANCE INFORMATION

  - COMPANY MUST HAVE BANKING ARRANGEMENTS TO COVER NEGATIVE LEDGER BALANCES

  - CIRCULAR DTC'S AND CREATED LEDGER BALANCES ARE PRACTICES INCONGRUENT WITH FED OBJECTIVES.

- THERE APPEAR TO BE MORE EFFICIENT MOBILIZATION PROCEDURES.

ARTHUR YOUNG

ARTHUR YOUNG & COMPANY
277 PARK AVENUE
NEW YORK, NEW YORK 10172

July 28, 1982

Mr. Thomas J. Kavaler
Cahill Gordon & Reindel
80 Pine Street
New York, New York 10005

Dear Mr. Kavaler:

We have completed our review of the cash mobilization procedures for your client, E.F. Hutton. As discussed in our engagement letter of June 17, 1982, the objectives of our study were to review the proposed cash mobilization system and procedures of your client and determine whether such procedures were reasonable and consistent with existing industry practices.

We concluded our work on July 8, 1982, with an oral presentation to E.F. Hutton personnel. The attached agenda for our meeting. summarizes the conclusions presented. We believe it is important to emphasize two important considerations presented at the presentation:

- The conclusions made as to the efficiency of the new procedures were drawn without a review of the firm's operating procedures and were based upon the assumption that the branch operations personnel would be competent in completing the new instructions.
- There are other procedures which could be implemented which would be simpler than the proposed procedures and be more effective in drawing down balances. A modification to the proposed procedure or another alternative should be tested with live data prior to implementation.

As indicated in our proposal letter, we conducted interviews with two major brokerage firms and two large multi-location corporations. The purpose of these interviews was to review current cash mobilization procedures employed at the branch/store location. The responses are described by company. To ensure client confidentiality, no specific reference to the company or individual contacted has been recorded. Each firm contacted was informed that we were on a fact gathering engagement for a client. The discussion would be limited to the mobilization of cash from the point of sale locations. This would include the methodology employed, bank relations, and problems/opportunities encountered. We conducted these interviews under the specific agreement that the respondents' identity would not be revealed. Under these guidelines and confidentiality assurances, the interviews were conducted over a two week period through July 2, 1982.

We have enjoyed working with you on this important project and hope to have the opportunity of working with you again in the future. Should you have any questions regarding this letter or require further information, please contact Mr. William Scherer at 212-407-1874.

Very truly yours,

Arthur Young & Company

CAHILL GORDON & REINDEL

AGENDA FOR MEETING-JULY 8, 1982

A. PROJECT STATUS

B. CONCLUSIONS PRESENTED-JUNE 23, 1982

C. OBJECTIVES OF THIS PHASE

D. CONCLUSION AS TO THE EFFICIENCY AND EFFECTIVENESS OF THE NEW PROCEDURE

E. GRAPHICAL PRESENTATION

F. POTENTIAL IMPLEMENTATION CONCERNS

G. OTHER AREAS ADDRESSED

CONCLUSIONS PRESENTED-JUNE 23, 1982

- THE APPROACH APPEARS REASONABLE GIVEN THE TARGET BALANCE IS AN ADEQUATE LEVEL OF COMPENSATION AND THE BANK AGREES TO THE PRACTICE.

- THE APPRAOCH IS AN ACCEPTABLE PRACTICE WITHIN THE INDUSTRY.

- WE EXPRESSED CONCERNS THAT:

  - CERTAIN BANKS MAY NOT BE ABLE TO PROVIDE COLLECTED BALANCE INFORMATION. THEREFORE, THE COMPANY MUST HAVE BANKING ARRANGEMENTS TO COVER NEGATIVE LEDGER BALANCES
  - CIRCULAR DTC'S AND CREATED LEDGER BALANCES ARE PRACTICES INCONGRUENT WITH FED OBJECTIVES.
  - IMPLEMENTATION UNDER THE CURRENT PLANNED WORKSHEET SHOULD BE INSTITUTED ON A REGIONAL BASIS.

- THERE APPEAR TO BE MORE EFFICIENT MOBILIZATION PROCEDURES SUCH AS:

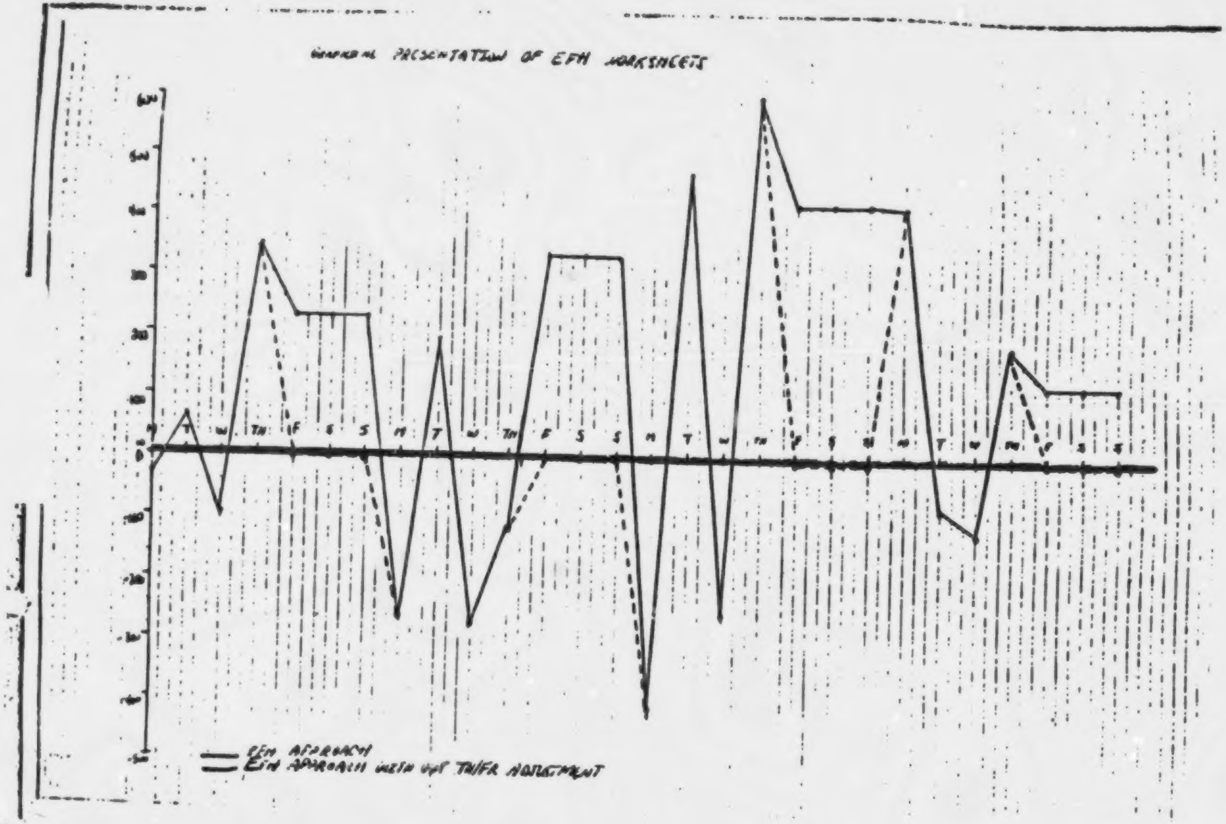
  - AUTOMATED CLEARING HOUSE (ACH) TRANSACTIONS
  - CENTRALIZATION OF TREASURY INFORMATION.

OBJECTIVES OF THIS PHASE

- REVIEW EFFICIENCY AND EFFECTIVENESS OF EFH PROCEDURES.
- TEST EFH APPROACH USING ADDITIONAL DATA AND MODIFYING ASSUMPTIONS.
- IDENTIFY POTENTIAL ENHANCEMENTS TO PROCEDURES.

CONCLUSION AS TO THE EFFICIENCY AND EFFECTIVENESS OF THE NEW PROCEDURE

- NOT AS EFFICIENT AS IT COULD BE DUE TO:
  - EXCESS COLLECTED BALANCES IN THE ACCOUNT IN PART DUE TO THURSDAY/FRIDAY ADJUSTMENTS
  - LARGE FLUCTUATIONS IN DAILY COLLECTED BALANCES DUE TO DOUBLE DRAWDOWN PROCEDURE.
- AS A RESULT OF THESE INEFFICIENCIES:
  - BANK BALANCES ARE NOT ADEQUATELY CONTROLLED AND TARGET BALANCES MAY NOT BE ACHIEVED
  - CASH IS NOT MOBILIZED AS QUICKLY AS POSSIBLE.


GRAPHICAL PRESENTATION OF EFM WORKSHEETS
600
500
400
300
200
100
0
-100
-200
-300
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M
T
W
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S
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S
S
EFM APPROACH
EFM APPROACH WITH [illegible] ADJUSTMENT

POTENTIAL IMPLEMENTATION CONCERNS

- OPENING COLLECTED BALANCE DATA MAY NOT BE AVAILABLE FROM CERTAIN BANKS.

- LARGE VOLUME OF LATE DEPOSITS AND SAME DAY ITEMS MAY MAKE IT DIFFICULT TO ACHIEVE TARGET BALANCES.

OTHER AREAS ADDRESSED

- WE HAVE EXPERIMENTED WITH ALTERNATIVE SCENERIOS WHICH:

  - MOBILIZE CASH MORE EFFICIENTLY

  - ACHIEVE BETTER CONTROL OF BANK BALANCES

  - SIMPLIFY PROCEDURES

  THESE SCENERIOS SHOULD BE TESTED FURTHER WITH LIVE DATA.

- IT WOULD APPEAR THAT EFH SHOULD CONSIDER MOVING IN THE DIRECTION OF MORE SOPHISTICATED CASH MANAGEMENT SYSTEMS: i.e.,

  - BALANCE REPORTING SYSTEM FOR BRANCH ACCOUNTS

  - DEPOSIT REPORTING

  - ACH/DTC

  - "PAYABLE THRU" MECHANISMS

  - HISTORICAL DATA BASE FOR BRANCH CASH RECEIPTS

Interview with Arthur Young

September 25, 1985

Representing AY were William Renshaw and John Goodwin, auditors on the Hutton account, and Carl Liggio and Paul Ostling, AY in-house counsel.

AY's work for Hutton is divided into engagements by Cahill, Gordon and by Hutton.

Note that AY never reviewed the cash management system that was being investigated by the Justice Department. It only considered proposed systems, but even in the context of the proposals, it raised several concerns that were applicable to the system being investigated.

Hutton has implied in both public statements and correspondence with DOJ that AY reviewed the system under investigation, which review was used by Hutton to argue that the cash management system was not illegal. Hutton also implied that AY recommended changes in the system under investigation, which Hutton immediately implemented. See attachments.

First engagement by Cahill: In May 1982, Tom Kavaler of Cahill called AY to arrange a meeting to learn about cash management in the brokerage industry. A meeting in late May 1982 lasted 2 1/2 hours. Kavaler then called Ostling, a law school classmate, and told him they were looking for expert technical advice for an unidentified client. He asked Ostling to ensure that the matter was kept confidential.

A June 1, 1982 engagement letter retained AY to conduct seminars on cash management for Cahill lawyers, and to consider a proposed cash management process. Renshaw and two other AY auditors were assigned to the project.

A meeting several days later lasted 2 1/2-3 hours. AY taught the Cahill lawyers "cash management 101" but a drawdown process was not discussed. After the meeting, Cahill revealed that the client was Hutton and set up a second meeting for Hutton employees on June 11. Present for Hutton were Norm Epstein, Richie Genin, Robert Ross, Tom Morley, and Norm Chaleff, plus the Cahill lawyers. Hutton described its proposed drawdown process, which was to be implemented as soon as all legal and tecnical approval was given. AY opined that the system sounded fair but that they needed to take a close look. No one mentioned any legal proceedings against Hutton, even though the grand jury had been investigating for a couple of months.

Second engagement for Cahill: The purpose of this engagement, dated June 17, 1982, was to determine the reasonableness, acceptability, and efficiency of Hutton's proposed drawdown sheet. On June 23, AY met with Cahill to give them its preliminary conclusions about the reasonableness and acceptability. They orally expresssed several concerns. First, they were concerned that smaller banks might not have the ability to

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determine their collected balances. AY did not know the specifics of the current Hutton system, but knew that the purpose of the drawdown sheet was to enable Hutton to retrieve their collected balances from the bank the next day.

Second, AY originally believed that the proposed drawdown sheet would not permit Hutton to overdraft its bank ledger balance, but might enable it to draw on uncollected balances, for which Hutton would have to pay a service charge. After further review, though, AY determined that the sheet would not permit overdrafting of either the ledger or collected balances.

Third, AY opined that "circular DTCs were disapproved by the Federal Reserve. The objective of circular DTCs is, for example, to concentrate funds on the west coast, move them to the midwest, and then finally to the east coast. The danger is that the last bank in the chain may be left in an uncollected position. While AY had no evidence that Hutton might be engaging in this practice, it had heard that others in the industry might be.

Fourth, AY was concerned that the proposed system might enable Hutton to create ledger balances, or draw on uncollected funds. Again, this was a hypothetical situation. AY had heard that others in the industry might be trying to create Fed funds.

Fifth, AY recommended that the system not be implemented firmwide at once, but rather regionally, so that cashiers could be trained and errors avoided. Norm Epstein decided, however, to implement the system immediately and firmwide.

On June 28, AY gave the same oral report to Hutton.

On July 8, another meeting was held to focus on the efficiency of the proposal. AY recommended, for example, that Hutton use wire transfers instead of DTCs. AY noted that its review of the proposal was limited, and Hutton told AY it wanted a more detailed review. Cahill then instructed AY to work directly with Hutton. This marked the end of the Cahill engagement.

First Hutton engagement: AY performed a more detailed analysis of the proposed drawdown sheet. In September 1982, it selected at random 25 Hutton branches, and tested them during a specified 2-week period. AY notified Hutton in advance of the branches and time periods to be examined, inasmuch as it was necessary to tell the branches to retain the drawndown sheets for review (they were otherwise being thrown away immediately). It asked whether the system managed cash without creating a negative bank ledger balance, whether the banks were being compensated for their services, and whether the branches were using the sheet correctly. It discovered that the branches were leaving money in the banks over the weekend and recommended some changes in the sheet, including wiring funds in and out. It wrote 2 reports, in September and October, but never visited any of the branches.

Second Hutton engagement: This engagement involved a study of which banks were best able to provide wire transfer services. AY recommended several to Hutton, which chose Citibank and the Bank of America. AY does not know in how many branches this system was implemented.

Third Hutton engagement: This involved a review of Hutton's cash mobilization department. It began in December 1982 or January 1983. A report was issued in November 1983. Hutton rejected AY's proposal to revamp the whole department, so AY narrowed its proposal. Among other things, AY pointed out that Hutton had no formal bank compensation system, and recommended that Hutton have a Treasurer, so that banks would have a contact person. Their recommendations were related to good management internal control and good business practices. Hutton's customer accounting and cash debits were deemed acceptable.

Fourth Hutton engagement: This was an update on the drawdown sheet, done in the spring of 1984. It took 3-4 weeks. AY talked to the regional cashiers and some operations managers, but probably no branch cashiers. They found some mistakes and inconsistencies in the implementation of the drawdown sheet, but no abnormal amount of errors. Most of the mistakes were mathematical, and did not appear intentional. AY submitted a report to Hutton's general counsel, Tom Rae.

Litigation assistance: In August 1984, Cahill wanted to use Renshaw and Paul Beehler, an AY cash management expert, as experts in a litigation matter, but gave AY only a brief description of the case to keep AY "pristine." No engagement letter was sent, but according to AY, this is not unusual.

Cahill gave AY hypothetical examples about overdrafting, microencoding, and chaining but did not use examples specifically relating to Hutton.

AY continued in this role until Hutton pleaded guilty.

In November 1984, Cahill asked AY to prepare a primer on cash management and the Hutton drawdown system. Issues addressed included how funds move in the banking system and hypothetical situations involving chaining (i.e. whether it is ever acceptable; AY's response was that it sometimes is, as when a state has a unit banking system). AY used a past mid-Atlantic drawdown sheet, and a then-current sheet, to prepare the primer.

In this matter, Beehler did 60% of the work and Renshaw 40%. Once the primer was done, Cahill told Renshaw they needed a detailed factual analysis of the case. In February 1985, Beehler and Renshaw were involved in this task, but Cahill realized that, if they were to be used as expert witnesses at trial, Cahill should build a "Chinese wall" around them. John Goodwin was brought in to deal with the real life events in the Hutton case. This was a joint Cahill/AY decision, raised initially by Beehler.

Goodwin analyzed the Genesee and Huntington chains, based on a rough analysis by Beehler. They were provided with a drawing of what Cahill believed the chain to be (which turned out to be different from DOJ's description), and looked at the collected balances for November and December 1981. Goodwin also analyzed the Old Kent and Shreveport chains, using a six-month period. They found no consistent patterns, but most banks had positive collected balances, though some balances were negative. They did not examine why the chaining took place, or whether there were arbitrary and excessive drawdowns at the banks within the chains.

AY determined that the Genessee Country Bank had positive balances for the two-month period it reviewed. However, Goodwin admitted that it used the balance for the entire month of December, which included the $10 million Hutton deposited to cover its bounced checks before the bank closed its account.

In its review of the United Penn Bank in Wilkes Barre, Pennsylvania (also part of the Genessee chain), AY found an overdraft of $553,000 for November 1981, but a positive balance of $5.2 million for December. This amount also includes the $19 million Hutton was required by the bank to leave on deposit until certain deposits became collected.

Goodwin also analyzed the bank balances in the Commonwealth bank in Kansas City for 1983. DOJ had found consistently uncollected balances during that year; AY found consistently positive balances, using materials provided by Cahill. AY also reviewed an analysis, prepared by Hutton's internal audit department, of the account at the Bryn Mawr bank, which had complained to Hutton of uncollected balances in November 1982. AY found a basically positive collected funds position.

Hutton's response to AY's recommendations on how to implement a new system: Renshaw is satisfied that AY expressed its concerns about the proposed system to Hutton. It was then Hutton's prerogative to reject the recommendations. Even given what Renshaw now knows about the state of Hutton's legal affairs, he is not disturbed by the rejection of their recommendations.

AY's reaction to Hutton's characterization of AY's role: AY does not believe that it was "used" by Hutton to make it appear that they had reviewed the system later found illegal, and had determined that it was reasonable and acceptable. Ostling does not believe it is a permissible inference that AY played such a role, or at least, that Hutton intended to so imply. No one at AY had any problem with being "kept in the dark" for so long about the nature of Hutton's problems, or basing their analyses on hypothetical situations rather than the actual facts of the case.

Discovery of the illegalities: Renshaw found out in the summer or late fall of 1984 that "something was going on in Pennsylvania." He was not told at that time that a grand jury was investigating Hutton, or what the nature of the investigation was.

Arthur Young interview, September 25, 1985, page 5

In November 1984, AY's work papers were subpoenaed by the grand jury, but no one paid much attention because AY receives many subpoenas. After this subpoena, Cahill told the Justice Department that AY was providing assistance to them, and offered DOJ an AY primer on cash management at Hutton and on the drawdown sheet. AY viewed its role as an agent of Cahill; thus it believes that the attorney-client and work product privileges applied to their work.

AY was unaware until we told them that months before AY was told about the grand jury proceeding, Cahill was offering AY's assistance to DOJ.

A second subpoena was issued for Paul Beehler to testify in April 1985, but he never testified because one week later Hutton pleaded guilty.

ARTHUR YOUNG

SUMMARY OF STATEMENT OF ARTHUR YOUNG & COMPANY BY PAUL J. OSTLING, WILLIAM RENSHAW AND JOHN J. GOODWIN, BEFORE THE HOUSE JUDICIARY COMMITTEE'S SUBCOMMITTEE ON CRIME (HON. WILLIAM J. HUGHES PRESIDING) HEARINGS RELATING TO E.F. HUTTON

OCTOBER 3, 1985

Arthur Young & Company ("AY") was initially retained by E.F. Hutton's Counsel, Cahill, Gordon & Reindel. Prior to August, 1984, AY performed engagements for Cahill Gordon (June 1-July 8, 1982) and Hutton itself (July, 1982-August, 1984). During this period AY was not involved in considering or reviewing the transactions under investigation by the Department of Justice. AY was not told that a criminal investigation was underway or that anyone had questioned the propriety of Hutton's cash mobilization practices. AY only knew that it was to assist Hutton's Counsel in their provision of legal services to Hutton and to advise Hutton prospectively with respect to cash mobilization practices. AY did not conduct any audit or detailed review of Hutton's actual cash management transactions during these engagements, either for the pre- or post-June, 1982 periods.

As a result of its initial work, AY concluded that the proposed drawdown sheet procedure it reviewed between June, 1982 and August, 1984 is a reasonable and legal procedure which should not result in overdrafting or the abuse of banking relationships; provided, of course, that its instructions are followed.

Between August, 1984 and August, 1985, AY personnel performed additional litigation support services for Cahill Gordon:

- As Expert Consultants: AY's Paul Beehler and Bill Renshaw discussed hypothetical scenarios relating to cash management practices and prepared a lengthy report describing contemporary cash management practices and Hutton's drawdown sheet process (including two drawdown sheets utilized by Hutton prior to June, 1982). Had the pre-1982 drawdown sheet been used appropriately, before 1982, the problems besetting all parties would be considerably less. During this process neither Beehler nor Renshaw audited or reviewed Hutton's actual cash management transactions for either the pre- or post-June, 1982 periods.

- Analysis of specific situations presented by Counsel: From February through August, 1985, AY, under the supervision of Jeff Goodwin, performed detailed analyses and modeling of "chains" and certain other banking relationships (including the Hutton restitution model), reviewing certain Hutton branch bank records as specifically directed by Cahill Gordon so they could analyze them.

During the entire course of its relationship with Hutton and Cahill Gordon, AY never served as Hutton's auditor and never conducted an audit of Hutton's cash management transactions. "Audit independence" was never relevant to AY's engagements. Rather, to enable Cahill Gordon to better represent Hutton and to allow Hutton to resolve some management operations concerns, AY performed consulting services which were clearly within its proper scope of services. There was no "conflict of interest" for AY, nor did AY, in accepting these engagements, violate any rule, guideline, or pronouncement relating to the legal or accounting professions.

Mr. **Hughes**. I thank you.

Mr. Beehler, do you have an opening statement?

Mr. **Beehler**. No, I do not, Mr. Chairman.

Mr. **Hughes**. All right.

So the bottom line, basically, is that you were retained as expert consultants to Cahill Gordon, who was acting on behalf of E.F. Hutton to provide expert testimony, support testimony, in conjunction with the E.F. Hutton matter.

Mr. **Ostling**. Mr. Chairman, certainly that was our initial engagement and our introduction to the matter. And it, again, became our primary mission and our only mission as of August 1984 and forward.

Mr. **Hughes**. Up until the third retainer, which is when you began developing additional work in connection—additional support work—for, again, Cahill Gordon in connection with the preparation for trial of that case.

Mr. **Ostling**. Yes.

Mr. **Hughes**. In fact, you were still retained by Cahill Gordon as expert support when the grand jury—when the indictments—resulted in a plea bargain.

Mr. **Ostling**. Yes, Mr. Chairman, and after that date.

Mr. **Hughes**. Yes. OK.

Now, at any time during the time that you were retained, on any of the occasions—the first occasion, when you were initially retained or the second or third occasion—did you ever render any opinion to Cahill Gordon or E.F. Hutton concerning the legality of their cash management practices?

Mr. **Ostling**. No, Mr. Chairman.

Mr. **Hughes**. I'm going to put in the record a memorandum, interoffice memorandum, of E.F. Hutton, dated April 4, 1983, from Michael P. Castellano, on the subject of the audit committee meeting, and which there is a note at the bottom which I am going to read to you.

Is there objection to placing this in the record?

[No response.]

Mr. **Hughes**. If not, so ordered.

[The document referred to follows:]

[Inter-office memorandum from E.F. Hutton, Apr. 4, 1983]

To: The File.
From: Michael P. Castellano.
Subject: Audit Committee Meeting.

A telephonic Audit Committee meeting was held on Thursday, March 24th, from 4:30 P.M. to 5:30 P.M.

Those attending were Tom Lynch and Mike Castellano from Corporate Headquarters, Joel Miller and John Tesoro from Arthur Andersen & Co., Warren Law and Edward Cazier from the Audit Committee and Bud Crary.

The topics discussed were as follows:

6. Bud Crary asked why the Pennsylvania District Attorney investigation on our use of over-drafting procedures was not mentioned in the 10-K. Tom Lynch stated we did not feel it was material. It did not have a material effect on our reduction of interest and Arthur Young performed a special review to which they concluded that what we were doing was perfectly correct and legal and that there was no need to indicate it in the Annual Report or 10-K.

Mr. **Hughes**. Let me read this—and I just had staff give you a copy.

"Bud Crary"—incidentally who is Bud Crary, do you know offhand? Obviously he's an E.F. Hutton employee—"asked why the Pennsylvania district attorney investigation on our use of overdrafting procedures was not mentioned in the 10-K. Tom Lynch stated we did not feel it was material. It did not have a material effect on our reduction of interest and Arthur Young performed a special review to which they concluded that what we were doing was perfectly correct and legal, and that there was no need to indicate it in the annual report or 10-K."

Had you ever seen that before?

Mr. Ostling. I saw this just prior to our beginning this afternoon's session, after lunch, when it was shown to me by a member of your staff.

Mr. Hughes. Is that an accurate statement? Did Arthur Young actually provide that advice to E.F. Hutton?

Mr. Ostling. Mr. Chairman, we did not perform any services with respect to E.F. Hutton or with respect to Cahill Gordon that related to giving any legal opinions. And we were not retained—and to the best of my knowledge, rendered no opinions or reports with respect to what ought to be indicated in any annual report or 10-K.

Mr. Hughes. Well, if I understand your testimony correctly, in chief, what you testified to was that you never looked at the cash management procedures, as such, of E.F. Hutton.

Mr. Ostling. I believe, Mr. Chairman, that we looked at drawdown sheets of E.F. Hutton, and in the period from June 1982 through October 1982, we looked at the drawdown sheet which was implemented after June 1982. I believe it was July 19, 1982.

There did come a time in early 1984 when we looked at that drawdown sheet again. And again, in connection with the blue book, which we have affectionately called it, a document which was prepared by Mr. Beehler and Mr. Renshaw for Cahill, and which was submitted, we understand, to somebody in the course of their activities in defending E.F. Hutton, there was another look at two drawdown sheets which were in effect prior to 1982, but in none of those cases did we look at live data or audit or conduct operational reviews of the drawdown sheets.

Mr. Hughes. Well, so what you are saying is that you did advise E.F. Hutton that what they were doing from those drawdown sheets was perfectly legal and proper? Do I take it from your testimony that you did give that advice?

Mr. Ostling. Give Hutton advice that——

Mr. Hughes. You have before you the statement that was made in reference to Bob Crary's inquiry as to why the Pennsylvania district attorney investigation on the use of overdrafting procedures was not mentioned in the 10-K that they had to file, and Tom Lynch, who, as you know, was then president——

Mr. Ostling. I should, if I might, respond, Mr. Chairman. I polled our panel before coming up here and determined that none of us knew Mr. Lynch at the time this was written. In fact, three of us I don't believe ever met Mr. Lynch, and Mr. Beehler only met Mr. Lynch after he left Arthur Young in late June of—or rather at some time around June 1985.

Mr. **Hughes**. Well, let's forget it's Mr. Lynch, an officer of the company at headquarters is making the statement that Arthur Young had performed a special review to which they concluded that what we were doing, Arthur Young concluded, "What we were doing was perfectly correct and legal," and that there was no need to indicate the overdrafting procedures in the annual report for 10-K, or the investigation by the Pennsylvania district attorney.

Did you give that advice?

Mr. **Ostling**. With all due respect, I don't know what the writer of this memo means. I can say that what we did is what we've described to you, and we did not conduct reviews which led to any opinions or statements about the 10-K, nor did we give any legal opinions about any drawdown sheet at any time.

Mr. **Hughes**. So, then, that statement is not correct.

Mr. **Ostling**. Mr. Chairman, if that is how you interpret the statement——

Mr. **Hughes**. No, no, no. I'm asking you—don't get cute with me—I'm asking you the question. You know, you know what you did, and we're trying to find out. I've asked you if, in fact—the statement is made here, and I have to take it at face value, that, in fact, what they were doing by way of overdrafting procedures was correct and legal, that they were advised by you, Arthur Young, that they were correct and legal.

Now, it's a very simple question, did you give them that advice?

Mr. **Ostling**. We never, as far as I know, and I defer to the members of the panel, we never gave any advice about any system relating to, quote, "overdrafting," close quote.

Mr. **Hughes**. And the answer is, it's not that you did not give that advice.

Mr. **Ostling**. With respect to overdrafting practices?

Mr. **Hughes**. Yes.

Mr. **Ostling**. That is correct.

Mr. **Hughes**. That is what it's referring to. You've got it before you there.

Mr. **Ostling**. That is correct. We did not give advice about overdrafting practices.

Mr. **Hughes**. The gentleman from Florida.

Mr. **Shaw**. Thank you.

Mr. Ostling, I find your comment or statement incredible, that you did not know that the grand jury investigation was going on or that Hutton—you told us that Hutton did not tell you that; but I believe you, because it's consistent with everything else that we have heard with regard to Hutton. I have never known of a company that was—I guess you would have to describe it as in modules more than anything else, and everybody was kind of doing their own thing. And how in the world they ever made money and expanded, I don't know, even with the overdrafting situation being a significant income item.

I would like to ask you, Mr. Beehler, would you describe the present system, as I understand that you are the architect of it, and as I understand, also, you work now for E.F. Hutton and run it, I'd like, if you could describe to us how it works and also, then, describe how it differs from the system that got E.F. Hutton in all this trouble.

Mr. **Beehler**. Yes, Mr. Shaw, I'd like to clarify that I did not design the system that is in place right now. We're using what we call a very simplified drawdown procedure. To contrast it with the prior procedure that was in effect, just in terms of its mechanics, it only takes into account today's deposits and reports, exactly today's deposits, as I understand it, to move the funds out of the field. There are no adjustments taken into account for same day or on items that go into checking accounts. Therefore, there is over time, understandably, a buildup of balances at our local bank accounts which we have experienced over the past several months.

However, that's only the mechanical difference in terms of what's being done today. During the last 3 months we've implemented a new organization which includes a treasury control group within our operation. We receive automated reports daily which track the activity coming into the branches and have just implemented the first of three phases which cover two major systems that we have developed, designed and are in the process of implementing. Those systems will provide same-day, on-line information from each of our branches in terms of their transaction activity, amount of draw-downs that they're reporting in.

Mr. **Shaw**. And how does that differ from before?

Mr. **Beehler**. Previously, before the development of the systems and the controls that we have in place now, each of the branches would create their own drawdown amounts. Those would be telephoned in—that is a single number for drawdown—to a region. The region, at that point in time, would concentrate the funds regionally, and then, of course, tell New York how much was coming in, and then they would transfer the funds out.

Under the new system we will, electronically, from New York, centrally concentrate all those funds directly into New York from the branches, into a New York concentration bank.

Mr. **Shaw**. So, the overdraft situation, I see here, for 1984, I show it as $405 million. That's a correct figure but it's an overdraft because it's uncleared funds.

How does that work?

Mr. **Beehler**. I'm unclear what makes up that $405 million for 1984, and I looked at those numbers and could not intelligently comment upon them.

Mr. **Shaw**. All right, well let me just ask you, then.

You're still running a large overdraft account within the company, but it's done—how is it done? Why is it an overdraft if the money's in the bank? It should be uncollected funds.

Mr. **Beehler**. Mr. Shaw, we are not running a system that will, in any way, result in an intentional overdraft at the bank.

Mr. **Shaw**. Then the accounts now—the money is not transferred out until it is deposited, but it is transferred out on uncollected funds; is that the situation?

Mr. **Beehler**. No, it is transferred out on a next-day basis. We make no adjustment for the fact that we deposit good funds today and that the bank has use of those good funds for one extra day before our concentration check is received by the bank.

Mr. **Shaw**. OK, but during that day they're in collected funds, aren't they?

Mr. **Beehler**. Pardon me?

Mr. **Shaw**. Aren't they uncollected funds as far as the bank is concerned during that day?

Mr. **Beehler**. Are they uncollected funds? Based on the total——

Mr. **Shaw**. Uncleared checks.

Mr. **Beehler**. Yes; but if you looked at the bank's balances, you'd find a deposit of ledger and a deposit of collected balance at the bank.

Mr. **Shaw**. Yes, I understand that.

Mr. **Beehler**. We're not running anything in balances.

Mr. **Shaw**. I yield, Mr. Chairman.

Mr. **Hughes**. The gentleman from Kentucky; 5 minutes.

Mr. **Mazzoli**. Thank you, Mr. Chairman.

Gentlemen, let me get back to what I think our chairman talked about, or maybe Mr. Shaw, and that is how you got drawn into this thing and under what premise you were contacted, and, given the nature of this thing, why you didn't seem to have any knowledge of the existence of a court case or of any concern, officially, on the part of Hutton that what they had been doing in cash management was the subject of an official legal inquiry or at least was something that they were concerned about, and that's why they called you in. I have to honestly say it seems—it's almost implausible for me to feel like you, a big, giant operation like yours, was drawn in and you don't get that kernel of truth and knowledge that there's something smelly going on and we're being called to correct it or give advice on how to do it differently.

Mr. **Ostling**. I think, Mr. Congressman, that at that time when we were called in, we were called in by a very reputable law firm, and, in fact, the partner who made the contact has been known to me for more than 15 years, and I went to school with him. We have had knowledge of this law firm in our firm for years. We were retained to do a litigation support engagement, and as you are probably aware, in those circumstances, when you are called in by counsel to assist counsel, you are given the information that counsel wants you to have to form some kind of conclusion or opinion based upon your expertise. That is how we got in at first.

Mr. **Mazzoli**. When you say "litigation," you mean with respect to that pending litigation?

Mr. **Ostling**. We frankly were not informed about——

Mr. **Mazzoli**. How do you say you were in there as litigation associates or litigation experts, but you didn't know what litigation was involved?

Mr. **Ostling**. Because counsel didn't tell us what litigation was involved.

Mr. **Mazzoli**. Do you mean to tell me I can call you now, I could call Arthur Young, and say, "Look, I need your advice because we've got some big lawsuit, and it's something that I'm concerned about," and you don't even ask the question, "Well, what sort of lawsuit is involved? Where is it? Who's involved? Who's the plaintiff—defendant?" You don't ask any questions?

Mr. **Ostling**. I think it depends who calls us and asks us that question. When——

Mr. **Mazzoli**. All right, so you say here—and I wrote it down—a reputable law firm called you. You were here when we had the panel of CPA's in here from Arthur Andersen, who, at least in part, were moved to go along with the scam because everybody else was doing it. So, you know, if every firm does it, then everybody is entitled to do it, and, in effect, if everybody is doing something wrong, then that thing becomes right.

Because your law school friend or some member of a reputable law firm calls you, then that means that you turn off your questioning button? I mean, you pull out the plug and don't ask any questions?

Mr. OSTLING. Absolutely not, Mr. Congressman.

Mr. MAZZOLI. Well, then, why did you not ask questions, very simply, "My friend, Charlie, what case are you involved in?"

Mr. OSTLING. Well, that was none of my business. But, however——

Mr. MAZZOLI. You'll understand if I sound just a little skeptical; and I don't want to be that, because I know that you guys are reputable, good people. But we have fixed our posteriors to these chairs, now, for weeks in a row, and the only thing we're getting out of witnesses is saying:

> Well, don't look at me, look at the other guy. You know, I didn't know, I didn't ask a question, I didn't hear it, I wasn't there when it happened. I didn't—you know I have no reason to know it.

The question that I guess really kind of moves me to become perhaps a little bit skeptical, kind of so, is the fact that this gets back to my experience in the intelligence community on that Intelligence Committee, everything is built on plausible deniability—construct the situation, the scenario, so everybody can deny they were a part of it, and yet the thing goes on merrily down the road. And nobody but nobody is ever involved.

Now, tell me, isn't that something I could be logically led to when I hear that a firm like yours is pulled in as litigation expert or counsel, and you don't even ask what litigation you're being called on for?

Mr. OSTLING. With all due respect, sir, I believe that it would have depended on what we found when we met with counsel, and then afterward, when we worked with Hutton.

Mr. MAZZOLI. Let me ask you this.

Mr. OSTLING. It was a good question. I'd really like to respond to it.

Mr. MAZZOLI. OK, thank you. Go ahead.

Mr. OSTLING. When we got in there, it's not like we found worms crawling through the woodwork. When we got in we were asked to review a proposed drawdown sheet. We reviewed that proposed drawdown sheet and found and reported upon it, that it was reasonable and acceptable and consistent with what was the practice, in our view the appropriate practice.

Now, if we had come in there, and we had been told that someone was kiting checks or doing malicious overdrafting or chaining or any of the other events, I'd agree with you 100 percent, our periscope and our flag would have gone up.

Mr. MAZZOLI. In the real world you're never told those questions, anyway. You're never told anything, you've got to ask in the real world. You're a lawyer, you realize you have to ask a question, nobody's going to propose that to you right off the top.

I guess the question is, how come nobody seems to ask any questions. It's almost as if the word has gone out, "Don't ask any questions." The less you know the better off you are, don't get down to the heart of it, just keep kind of working around the edges and then everybody's protected, because you can honest to God say to a committee, under oath, "I didn't know." That's the advantage of deniability, "I don't know anything."

And the question, then, is, "You don't know it?" "I agree, you're not lying to us." You could be cuffed right now and the meter won't go bong, because you're telling the truth. But the question I ask is, why didn't you ask? Why don't the CPA's raise the question? Why are they not motivated to go a little bit deeper into it?

Mr. **Ostling**. I can only speak for us.

Mr. **Mazzoli**. Yes.

Mr. **Ostling**. I think our record stands on its own, subject to the sunlight. And I think our reputation for being inquisitive and having a healthy skepticism in everything we do at Arthur Young stands on its own.

Mr. **Mazzoli**. Well, let me ask you this. Wouldn't it be logical, sir, if you were called in as a litigation counsel to examine a proposed drawdown sheet, assume that you don't feel like you need to ask any questions about what litigation is involved, so that you don't know that another drawdown system is under scrutiny, legal care, wouldn't it logically come to you or any lawyer that you assigned to the task that, "Well, maybe something's wrong with what they're now doing in cash management." I mean, is that so stretching the scheme of logic to say that even if you fail to ask about the litigation, which would fail to elicit the fact that a current drawdown system is under scrutiny, wouldn't it be logical to see, if you're going to look at a new drawdown system that the old one must be under fire?

Mr. **Ostling**. With all due respect, I do not believe so.

Mr. **Mazzoli**. Like I say, the machine won't go bong because you're telling me the truth, but it just makes me worry a lot about our profession. I'm a lawyer. I think our profession and certified public accountancy is a profession, sometimes other ones, they sort of look away. The reason why people distrust all of us is the fact that we don't, sometimes, ask the question, we don't go that extra mile to assure that the public is served, and the public feels that their interest, or at least in part, is involved in our deliberations. As a politician I'm constantly becoming aware of that. At my forums people don't seem to think we care.

I just, with respect, wonder if a lot of this grief couldn't have been avoided if somebody were to, once in a while, ask a cogent question, and say, "Look, I think a big scam is being pulled here, and I think I smell a rat, and tell me a little bit more about it." But if you never ask the question, if you just accept what people give you, they're never going to give you anything but their side of the situation, which is the proper side.

I don't know, I guess the only question I have Mr. Beehler, do you, in this new system that is put in in Hutton, is there ever, anytime, a check that is written when there are not funds to cover that check, when the bank upon which that check is written doesn't have some kind of an understanding with you that it's OK?

Mr. BEEHLER. No; under the system that I describe, which is an interim system whereby we will not overdraft the banks is subject to the consent, in the future iteration or the second phase of the system we will only implement that; that is a modified drawdown procedure for those banks who have signed the consent forms.

We have a very tight control right now over the banks with whom we're dealing. One of the two systems I had mentioned earlier is a bank information system. We have changed our policies and centralized responsibility for our over 465 banks within our division to monitor and manage all of our bank relationships. That includes the consent forms for the drawdown procedures. No bank will be put onto that modified system until we have a signed consent form in our files.

Mr. MAZZOLI. I thank you, Mr. Chairman.

Mr. SHAW. Mr. Chairman.

Mr. HUGHES. I'm going to put in the record a memorandum dated May 17, 1982, to cashiers from Robert Mencer. It's an E.F. Hutton interoffice memorandum.

Is there objection?

[No response.]

Mr. HUGHES. Hearing none, so ordered.

[The document referred to follows:]

[Inter-office memorandum from E.F. Hutton, May 17, 1982]

To: Cashiers—Pacific North & South, CC: Branch Managers.
From: Robert Mencer.
Subject: Drawdowns.

As promised in Friday's wire, here is the clarification regarding the banking drawdowns. We told you to discontinue use of the worksheet and to bring your bank balances to zero. Also, we informed you that the cut-off time for calling in drawdowns to ALC would be extended to 1:30 P.M.

The example offered Friday to bring your bank accounts to zero still is in effect. But starting today, you must call in the amount of your daily drawdown by 1:30 P.M. as follows:

1. All customers' checks (and cash) received by the cut-off must be blottered, transmitted by wire, and deposited at the bank. Remember, you can prepare blotters, have wires transmitted and go to the bank after the cut-off.

2. All checks received after the cut-off may be blottered and deposited at the bank, but they cannot be transmitted over the wire because they will not have been included in the drawdown.

3. It is not mandatory to deposit checks received after the cut-off but it is recommended. If the amounts are in excess of $25,000 and it is possible to take them to the bank, we urge you to do so. Those checks that cannot be deposited, must be placed in the night drop bag.

4. There are many offices reporting to Los Angeles, thus it is not possible for all of you to call at exactly 1:30 P.M. Therefore, you must cut-off as close to 1:30 P.M. as possible, is order to have called by 1:30 P.M. Please note, and this is important, your telephone call is your actual cut-off. Once you have called in the drawdown, all checks received afterwards cannot be transmitted by wire even though you may be able to deposit them in the bank.

5. It is no longer necessary to estimate late deposits since moneys received by your cut-off will be included in the drawdown and those received after you have cut-off will not be transmitted (whether they are deposited in the bank or placed in the night drop bag).

6. If your bank balances finish in the negative, that is, in the red, you must bring them to zero by depositing a U.S. Trust check. Since you do not generally disburse local funds, this should not be necessary too often.

7. Here again is the example for determining your drawdown: Opening EFH ledger balance on our books; Plus today's deposit; Minus local checks if any; and Net balance to be drawndown.

To summarize, effective right now, all bank balances will be brought to zero, repeat zero balance and you will disregard the drawdown worksheets. The cut-off time for calling in drawdowns is now 1:30 P.M. Anything received after the cut-off will be transmitted the next day. If there are any questions, you may contact the Regional Cashiering Dept. and talk to Bob Hein, Helen Levis or Mark Willets.

Branch Managers and Cashiers—Please Note.—While on the subject of banking procedures, let me comment on the processing of disbursements (payment of BOA drafts). Because of the drawdown cut-off, we cannot transmit deposits after determining the amount to be drawndown but this cut-off does not apply to the reporting of payments of BOA drafts which can be transmitted much later. In fact, it is imperative to transmit all drafts paid each day if possible. Since the wire system shuts down at 3:15 P.M.—Pacific Daylight Time—it is possible to process BOA drafts much longer. Since you need some processing time, I am setting 2:45 P.M. (Pacific Time) as the cut-off for transmitting BOA disbursements. Those offices where the wire operator leaves before this time must have a trained back-up operator or cashier who can transmit drafts.

P.S. Managers Please Note.—

1. The failure to transmit BOA drafts the same day they are paid negatively impacts your interest P+L. Every effort should be made to transmit BOA drafts as late as possible.
2. Receipt of customer deposits up to 1:30 P.M. must be processed the same day. Failure to do so will result in interest adjustments and problems with CRM orders etc. Deposits received after the 1:30 cut-off must not be transmitted.

Mr. Hughes. Would it be safe to say that when you were brought in in June 1982, you were asked to look at some hypothetical drawdown sheets for an opinion as to whether or not that would be standard, proper practice? Would that be one of your major roles at that time?

Mr. Ostling. I would defer to the people that did the engagement.

Mr. Renshaw. Mr. Chairman.

Mr. Hughes. Mr. Renshaw.

Mr. Renshaw. Would you please repeat the question?

Mr. Hughes. Yes; my question is, would it be safe to say that when you were brought in in June 1982, one of your primary reasons for being retained was to look at some hypothetical drawdown sheets to advise E.F. Hutton, or Cahill Gordon at that time, as to the propriety of those sheets? Would that be a safe explanation?

Mr. Renshaw. We were asked to take a look at a proposed sheet, so there would be one sheet there, and that one sheet was whether it was acceptable as a practice.

Mr. Hughes. The reason I just put this memorandum actually in the record is that it's interesting, and my colleague, I know, from Kentucky, will be interested, that even though the management, the top management at E.F. Hutton, contends that they didn't know anything about the illicit practices—the illegal practices—that when the grand jury subpoenas were served, about May 12, 13, in there somewhere, 1982, there was a memorandum that went out to all the cashiers to close down the drawdown operations. So, it just defies logic that they didn't know. They would have no way of knowing what the grand jury, of course, was going to inquire about, because the subpoenas had just been served. But they had enough knowledge to close down the drawdown systems.

You never looked at the, as I understand it, at the drawdown sheets that were being used prior to June 1982?

Mr. Ostling. Only for Cahill Gordon in 1984, in conjunction with a report we put together when we looked at two drawdown sheets that had been in use prior to 1982. As I say, our review of those sheets was just that, of the sheets, not the operation and the underlying transactions.

Mr. Hughes. I see, so you never looked at—you never did an audit, you never looked at whether or not they were complying with the drawdown sheets because at some point they just discarded the drawdown sheets and were just drawing down moneys with no reference to drawdown sheets. But you never looked at any aspect of that, you were never retained to do that, you never did that. Mr. Goodwin.

Mr. Goodwin. Mr. Chairman, in terms of some of the work which I did subsequently, in the months immediately prior to the plea and in the months immediately after, that's the only instance in which we reviewed facts concerning transactions through banks. We did not do that in conjunction with review of the drawdown sheet; however, we did look at some of the underlying transactions in that very limited context, not in the context of the review of the drawdown sheets themselves.

Mr. Hughes. But you never gave a clean bill of health to the operations at E.F. Hutton, or cash management practices.

Mr. Ostling. We were never retained to give such an opinion nor were we asked to.

Mr. Hughes. Does the gentleman from Florida have any further questions?

Mr. Shaw. Well, I don't know whether it's a further question or not, but I think it's something that's quite appropriate for this hearing.

The Hutton case concentration abuse of float in the cash concentration, I am curious as to what the impact on float abuse is in cash disbursement. This months Institutional Investor carries an article written by Barbara Donnelly, in which she finds:

> When control disbursement begins to look like yet another tricky game to create float, it sprays over the line into remote distribution and cash management has ventured into what Murray describes as a dark gray area. That would be true, for example, if a company has located its disbursement points in remote areas of the country, as far away from its creditors' banks as possible. And that is precisely the way the Justice Department now defines several services now being hawked through cash managers by banks and third-party service companies. One such device is the Troy Printer produced by the Troy Division of Data Card Corp. The printers' optical reader monitors each vendor's address as bills come in and then uses tables sold by Chicago consultant Phoenix Height to determine the bank combination of zip code location and disbursement bank for delaying payment of that item. Indeed, many banks actively advertise their appeal as "slow clearers." If a bank pops up as a great disbursement point on Phoenix Height then they really beat down your door, says cash management consultant Parkinson. If they get extra days, they offer to split the difference with you.

I think that may tell us the breadth of the problem and the situation that we do have. It certainly goes far beyond the particular industry in which Mr. Hutton—E.F. Hutton—is engaged. I think it's just a question of who gets the money on a float.

Thank you.

Mr. Hughes. Well, that sounds like a good place to conclude these hearings. In fact, it's a good place, anyway, to conclude the hearings.

Thank you very much for your testimony. You've been most helpful.

Mr. Shaw. Mr. Chairman, I'd like to ask unanimous consent to put that particular article in the record.

Mr. Hughes. Without objection so ordered.

[The information follows:]

COVER STORY

INSTITUTIONAL INVESTOR
SEPTEMBER 1985

The crisis in cash management

The fine line between smart and criminal

The saga started on a chilly Friday in December 1981, when the auditor at a small bank in an upstate New York town became suspicious about an $8 million check drawn against one of its customer's accounts. The story continued on and off for the next three years, as an unknown assistant U.S. attorney from rural Pennsylvania stubbornly pursued a complex paper trail of huge bank overdrafts. It ended on May 2 of this year, with a guilty plea by E.F. Hutton & Co., the nation's fifth-largest brokerage firm, to 2,000 criminal counts of banking fraud.

Since then, the headlines have all followed the ongoing investigation of which of Hutton's top executives knew about the fraud and when. But lost in the furor is the larger implication of the firm's guilty plea: the very way U.S. corporations manage their huge reserves of cash.

In a special report beginning on the following page, Associate Editor Barbara Donnelly explores the chilling effect the Hutton case will have on the massive movements of corporate cash in the banking system and on the aggressive ways in which corporate America plays the cash management game. Then, on page 80, Donnelly provides a unique, behind-the-scenes glimpse of how the Justice Department pursued its case against Hutton. It chronicles how Al Murray, the idealistic young assistant U.S. attorney who led the case, gradually became convinced that what most corporations viewed as savvy cash management practices were, in fact, illegal. And Murray's views eventually found their way into the precedent-setting injunction that, for the first time ever, drew legal lines around the cash management profession.

Both stories dramatically illustrate one fact: Corporations and their treasury departments will be dealing with the fallout from the E.F. Hutton scandal for many years to come.

COVER STORY

Cash management: Where do you draw the line?

The chilling fallout from the E.F. Hutton scandal shows that what many companies think is aggressive cash management could well be illegal.

by Barbara Donnelly

"Acceptable cash management," said Richard Adamski recently, "is anything you wouldn't mind your chairman explaining on the front page of *The Wall Street Journal*."

With that wry remark — one that's being repeated in many other corporate boardrooms these days — the treasurer of the Teachers Insurance Annuity Association College Retirement Equity Fund underscored the major, and largely overlooked, impact of the most highly publicized white-collar crime in years: the E.F. Hutton & Co. cash management scandal. The May 2 guilty plea by the nation's fifth-largest brokerage firm to 2,000 counts of unprecedented bank fraud did more than send shock waves through Wall Street. In bringing its case against Hutton, the U.S. Department of Justice has forced a major reassessment, and perhaps even a reversal, of the entire thrust of corporate cash management over the past decade: the use of aggressive techniques to maximize the money a corporation earns on its huge reserves of idle cash.

In a little-noticed civil injunction attached to the two criminal charges against Hutton after months of plea bargaining, the Justice Department for the first time draws legal limits around many cash management practices where none existed before. Among other things, the injunction reins in the way Hutton can use bank overdrafts and move its funds. It seeks to clarify the thin line separating aggressive cash management from fraud, and it serves notice on the nation's cash managers that henceforth some of their most basic tools will be subject to intense scrutiny by federal law enforcement officials. As assistant U.S. attorney general Stephen Trott puts it, "We're telling corporate America that these practices are unacceptable, and if you continue to use them, we may be knocking on your door."

A lot of companies that have been telling their cash managers to be aggressive and creative are going to start putting handcuffs on them

Josh Leong

The implications for cash managers are chilling indeed. Since the high interest rate environment of the 1970s, they have employed ever more sophisticated techniques to keep their companies' non-interest-bearing checking account balances at a bare minimum while maximizing excess cash to earn interest in the money market. Toward this goal, managements have encouraged their cash managers to be aggressive, in many cases providing them with incentives to run their operations as profit centers. "People used to be proud of a system that really pushed things to the maximum," says Jimmie Carter, the former director of cash and banking at TRW and now head of the Cash Management Academy. "They used to brag about it. It was the fashion."

Indeed, the cash manager's world became an increasingly fast-moving one, as he juggled funds between collection and bill-paying accounts, often dealing with dozens, and even hundreds, of banks across the country — all with the goal of not leaving a single dollar sitting idle when it could be earning interest somewhere. With bill-paying, or disbursement, accounts, that task isn't difficult; many banks provide their corporate customers with so-called zero-balance accounts, into which they can instantly transfer only enough money to cover checks as they are presented. A far bigger challenge for the cash manager is maintaining a minimum "target" balance in his collection, or concentration, account to compensate his banks for cash management services. Toward that end, cash management has enjoyed its finest hour as managers have moved funds around with lightning speed, using complex "multiplier" formulas that tell them how much

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The Hutton scheme

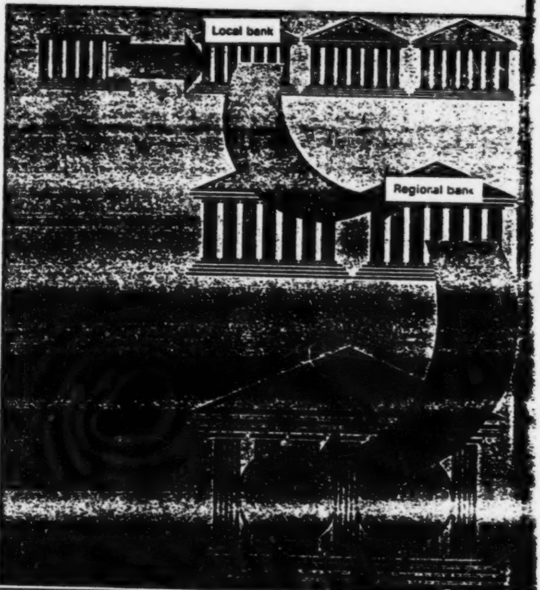
These diagrams graphically illustrate the more serious of the two criminal practices at the heart of the E.F. Hutton case: fraudulent use of its "concentration," or cash collection, system to write huge overdrafts aimed at creating interest-earning float. With Hutton's guilty plea to this charge, the legal line has now been drawn between legitimate overdrafts to "recapture" full use of a company's funds (left-hand illustration) and illegal *creation* of float (right-hand il-

How Hutton's system was supposed to work

1. Monday afternoon: In the first step of a "concentration" system designed to channel daily revenues from its branches to a central money center account, a local Hutton branch deposits $10,000 of customer receipts in its local bank. Of that amount, $5,000 is in the form of immediately available cash, $5,000 is in checks to clear Tuesday.

2. Monday afternoon: Hutton's regional office, on phone instructions from the branch, writes a $15,000 check on the local bank for deposit in its account at the firm's regional bank, to clear Tuesday. The reason for the overdraft: The local bank, and not Hutton, immediately begins earning interest on the $5,000 cash portion of the branch deposit left idle there; thus the regional office "recaptures" what it considers Hutton's legitimate use of its own funds with a $5,000 overdraft on which the firm can then earn interest for one day.

3. Monday afternoon: New York headquarters office, on phone instructions from the regional office, draws down a $15,000 check on the regional bank to clear Tuesday and deposits the check in the concentration, or collection, account of its central New York bank — where the money will be used to pay bills, retire debt or invest in the money market. On Wednesday the Hutton branch uses immediately available funds from customer receipts to cover the $5,000 overdraft from Tuesday.



they can deliberately write in overdrafts on some accounts.

With the Hutton case, the Justice Department has changed much of that. "A lot of companies that have been telling their cash managers to be aggressive and creative are going to start putting handcuffs on them now to stay within the strict limits of the law," says Chubb Group treasurer Philip Sempier. Moreover, adds Robert Ford, a vice president at Manufacturers Hanover Trust Co., those handcuffs will cost corporations money. The acceptable practices laid out in the Hutton ruling, he says, mean "you would always err on the side of conservatism and the only winners would be the banks. If you applied all the points of the injunction to the letter of the law today, there wouldn't be much cash management anymore."

Float free-for-all

At the heart of the Hutton case is a clash between the Department of Justice and cash managers over what constitutes legal use of "float" — that bookkeeping netherworld between the time when checks are written and when the money is actually collected. This precious time gap, created by delays in the clearing, processing and mailing of checks, has always been the focus of a tug-of-war between corporations, creditors and their banks, as each seeks to exploit it to its own advantage. Companies, for example, will often write legitimate overdrafts on their banks in order to reclaim, or "recapture," interest earned on float that naturally occurs in the system due to delays when banks clear or process checks. If the

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lustration). Most experts agree that this, coupled with broad disclosure requirements spelled out in a civil injunction against the firm — which requires companies to get their banks' written consent before writing any overdraft — will force a major reversal of the current trend toward aggressive cash management.

How Hutton abused the system

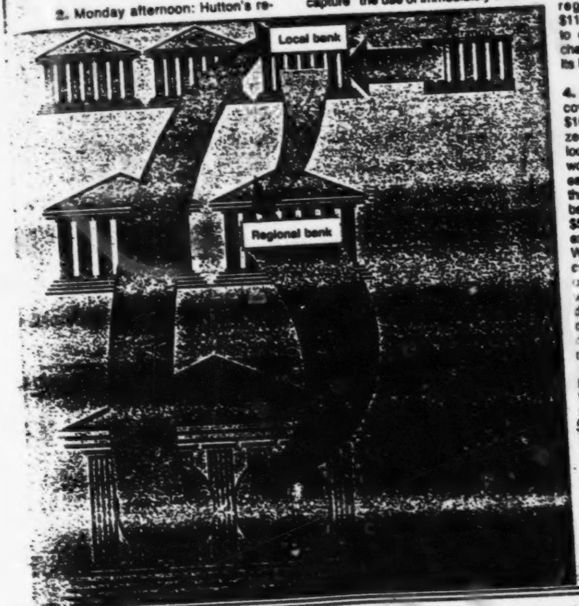
1. Monday afternoon: Local Hutton branch deposits $10,000 of customer receipts in its local bank. Of that amount, $5,000 is in the form of immediately available cash, $5,000 is in checks to clear Tuesday.

2. Monday afternoon: Hutton's regional office, on phone instructions from the branch, writes a $115,000 check on the local bank for deposit in its account at the regional bank, to clear Tuesday. Of that amount, $15,000 represents customer receipts and a small $5,000 overdraft to "recapture" the use of immediately available cash, as in the example at left. However, $100,000 of the amount is a huge, totally arbitrary and illegal overdraft, aimed at "creating" float on which Hutton can earn interest.

3. Monday afternoon: New York office, on phone instructions from the regional office, draws down a $115,000 check on the regional bank to clear Tuesday and deposits the check in the concentration account of its New York bank.

4. Tuesday afternoon: The branch covers the illegal overdraft with a $100,000 check written on Hutton's zero-balance disbursement account located at its New York bank, which won't clear until Wednesday at the earliest; sometimes it clears two or three days later because the local bank can't process it in time. The $5,000 "recapture" overdraft, as in the example at left, has been covered by Wednesday's immediately available customer receipts from the branch. By covering the overdraft with a check written on the New York zero-balance disbursement account, the branch has clearly abused the intent of that account — which is to pay company bills, not cover float-creating overdrafts.

5. Wednesday afternoon (or later): When the overdraft-covering $100,000 check clears, Hutton wires the $100,000 from its concentration account to the zero-balance disbursement account to cover it. In the meantime, the firm has earned money on what amounts to a minimum one-day interest-free loan — at the expense of its banks. This process repeats itself day by day, with the size of the overdraft tripled or quadrupled on weekends or holidays, to create float on an ongoing basis.



overdraft is in the same amount as the float, it creates no new float, and the company is, in effect, recouping the advantage temporarily gained by the bank from the use of its funds. The practice is not considered out of line, and the banks usually go along with it. Occasionally, however, companies — using what they have always viewed as simply aggressive cash management techniques — will go farther and write a larger-than-justified overdraft or deliberately delay the check-clearing process, thus artificially creating float themselves. Now, in the Hutton case, the Justice Department has sought to draw a legal line between the two practices — to clarify what it feels is illegal and legal in the float free-for-all.

The most serious criminal charge against Hutton — and the one with the most important implications for cash managers — involves the firm's complex and widespread scheme to create huge amounts of float artificially through what the indictment terms "arbitrary and excessive overdrafts." And in so doing, charged the Justice Department, Hutton defrauded its banks by misusing its concentration system — the sprawling network of banks the firm employs to move hundreds of millions of dollars of customer receipts from its 400 branches to central money center bank accounts each day. There the funds are gathered into huge cash pools, called concentration accounts, and used by the firm to invest in the money market, pay corporate debt and fund disbursements or bills from suppliers.

Used legitimately (see diagram, above), Hutton's concentration system —

"They were doing 170 in a 55-mile-per-hour zone while everyone else was doing only 75."

similar to the systems employed by many other companies with large networks of branches or stores — works this way: On Monday afternoon a branch manager in Lincoln, Nebraska, deposits $10,000 of the day's customer receipts in the local bank. Though the deposit won't clear until Tuesday, the branch manager instructs the regional manager to write immediately a $10,000 check on the Lincoln account for deposit in one of Hutton's nine regional concentration banks. On the same day, the regional manager in turn instructs Hutton's cash manager in New York to draw a $10,000 check — which will also clear on Tuesday — on the regional bank for deposit in either Manufacturers Hanover, U.S. Trust Co. or Chemical Bank, the firm's central concentration banks on the East Coast. Hutton also has a central concentration bank, Bank of America, in Los Angeles.

Occasionally, the $10,000 in receipts might contain $5,000 in cash, or in checks drawn on the Lincoln bank, and this $5,000 would obviously not have to wait until Tuesday to clear. The local bank would naturally earn interest on the cash portion of the deposit from Monday to Tuesday, which it would not pass on to Hutton. So, in order to "recapture" what he considers Hutton's legitimate interest on this $5,000, the branch manager creates a $5,000 overdraft for one day by instructing the regional chief to draw $15,000 instead of just $10,000 from the local bank. After the $15,000 check works its way through the concentration system and clears on Tuesday, the Hutton branch manager covers the overdraft on Wednesday with immediately available funds from customer receipts.

Hutton's use of overdrafts, in which it takes back the bank's temporary gain when a portion of the company's deposits are immediately available as cash or checks, is a common and legitimate cash management technique. It has often been employed by companies in "target balancing" — a strategy for ensuring that their banks aren't overcompensated for cash management services. Instead of charging fees for these services — which many cash managers would prefer — most banks generally require their corporate customers to maintain minimum, or "target," amounts in their non-interest-bearing concentration accounts. So to keep those balances adjusted to an average monthly level, many companies, like Hutton, employ a complex "multiplier" formula that calculates how much they might overshoot their targets on a given day because funds are immediately available or have been inadvertently left on deposit longer than necessary. The formula dictates the size of the overdrafts that companies can then write in order to recoup the interest earned by their banks on those excess funds.

Cash managers might use overdrafts in target balancing as a way to recapture "float" as well. If, for example, in the example cited above, the $10,000 check drawn Monday on the Lincoln bank experienced a processing delay and did not clear until Wednesday, it would be acceptable practice for Hutton to write an additional $10,000 overdraft for one day and recapture the float. There's no net cost to the Lincoln bank, since it has already enjoyed the use of the customer's deposit for an additional day. And Hutton, rather than the bank, winds up with a free one-day loan from the Federal Reserve.

Over the line

As long as Hutton's overdrafts had involved only this generally accepted recapturing of float, they would have remained within the range of what the Justice Department views as legitimate cash management practice. But Hutton stepped way over the line in two important ways. First, the huge overdrafts that about twenty of its branch managers put through its concentration network bore no connection to the firm's "multiplier formula" and were totally unrelated to either customer receipts or legitimate recapture. For example, a check for almost $10 million written against the account of Hutton's Alexandria, Virginia, office on November 2, 1981, was backed by less than $71,000 of customer funds. That same day a $925,000 check was drawn on the account of the firm's Williamsport, Pennsylvania, office based on only $92,500 of real business. On some days Hutton got use of some $250 million of free money this way.

Second, instead of covering the overdraft with immediately available branch receipts, the Hutton branch manager would write a big check on Hutton's zero-balance disbursement account, which the firm also maintains at its money center bank. Not until at least a day or two later, when the check cleared, would Hutton's cash managers actually transfer money from the concentration to the zero-balance disbursement account to cover it. In the meantime, the firm had earned a minimum of one day of interest on the overdraft and obtained what amounted to an interest-free loan from its banks.

This was clearly a fraudulent misuse of Hutton's zero-balance disbursement account, though the account itself is an accepted cash management service that many banks offer corporate customers. The accounts eliminate a company's need to maintain idle bill-paying balances by allowing it to wire money from its concentration account to its zero-balance account only when the checks are presented for payment. But instead of using these accounts to pay for business transactions, Hutton was using them to cover huge overdrafts on the collection side of its cash management system — and thus, in the view of the Justice Department, arbitrarily and fraudulently creating float at its banks' expense.

The local banks were led to believe that zero-balance checks represented deposits of local-customer funds consisting of immediately available and one-day money. But Hutton knew full well that the zero-balance checks would take at least one day, and often longer, to clear.

Hutton also knew that most of its banks couldn't tell collected from uncollected funds at any given time. This is because most banks, even the large money center institutions, only do a monthly analysis of their customers' accounts, and some don't monitor the accounts at all. Moreover, primarily because of technical problems, they monitor overdrafts by watching companies' ledger balances (the record of checks deposited but not cleared) and not collected balances (the record of cash that is immediately available). In other words, although Hutton would have a positive ledger balance in its concentration account, due to its deposits of its own checks, its big overdrafts created a negative collected position.

The magnitude and consistency of Hutton's overdrafts clearly put it in a class by itself. And it was this excess, says the Justice Department, that enabled it to bring fraud charges against the firm. As Albert Murray, the assistant U.S. attorney who led the Hutton case, puts it, "They were doing 170 in a 55-mile-per-hour zone while everyone else was only doing 75, so we could nail them." According to Larry Marks, head of Phoenix-Hecht, a Chicago cash management consultant, a couple of dozen companies have the same sophistication, opportunity, funds flow and geographical spread to do what Hutton did, but only a handful of them have the technical competence and drive. These are primarily large brokers like Hutton or huge retailing or fast-food chains with broadly dispersed operations around the country and a big volume of daily cash flows.

Corporate speeders

Nevertheless, though not as flagrant as Hutton's, overdrafting games to create float have been a staple of aggressive cash management for years. At a recent cash management conference, for example, the chief financial officer of one large industrial company bragged that he had pulled the same tricks as Hutton during 1979–1980, when high interest rates made them even more profitable — but he was now protected since the five-year statute of limitations had run out (which was not the case with Hutton, since Justice initiated its formal investigation in 1982). And B.P. Fulmer, an officer of National Bank of Georgia, estimates that a third of all cash managers "are doing the equivalent of 70 in a 55-mile-per-hour" zone through one aggressive practice or another. In working out their multiplier formulas, these cash managers will, for example, overestimate by a modest cushion the amount of immediately available funds on which they will recapture interest from their banks and write correspondingly larger overdrafts. "It's fairly common to use a multiplier formula to eke out a bit extra," confirms the Cash Management Academy's Carter. Adds another consultant, "Several major companies across different industries still employ this technique."

The Hutton case, however, now exposes these companies to a possible Justice Department investigation. The department has, for the first time, set the overdrafting speed limit and served notice that henceforth even lesser offenders risk prosecution. In a key tenet of the Hutton civil injunction — which now sets legal standards for the entire cash management industry — the Justice Department sharply narrows the scope of what it views as "acceptable" overdrafts. The tenet prohibits Hutton from "drawing down arbitrary amounts by means of overdraft checks unrelated to the volume of customer funds deposited and thereafter covering such drawdowns by checks drawn upon another of Hutton's accounts."

In other words, a line has now been drawn between legal recapture of float and illegal *creation* of float. From now on, a company must be able to prove that its overdrafts are amounts only large enough to recapture interest on float created by delays in check clearing or on cash deposits that a company was unable to invest immediately. Moreover, the Justice Department has warned the nation's cash managers that it considers target balancing a questionable practice in itself — a practice that, because it is used to recapture float, naturally lends itself to abuse. As assistant attorney general Trott puts it, carefully choosing his words, "There's nothing wrong with target balancing per se, as long as it's applied to an agreement with banks to adequately compensate them for their services."

Setting precedents

The key word here is "agreement." In four more precedent-setting provisions of its civil injunction against Hutton, the Justice Department has set forth broad disclosure requirements that, perhaps more than any other aspect of the case, will, in the words of NBG's Fulmer, "have a chilling effect on cash management." One provision would require cash managers to disclose, in writing, to their banks the complete details of any cash management practices that affect the banks, including such heretofore vague and undisclosed items as multiplier formulas and the size and means of achieving target balances. Moreover, they are forbidden to write *any* kind of overdraft on their uncollected bank balances without an explicit written agreement from their banks. And while the tenets refer only to the collection, or concentration, side of the cash management network, the Justice Department has told *Institutional Investor* that by implication the injunction covers the disbursement, or bill-paying, side as well.

"If you applied all the points of the injunction to the letter of the law today, there wouldn't be much cash management anymore."

The implications are far-reaching indeed. "Nine out of ten companies could find themselves in negative collected positions in the course of normal cash management," points out Paul Beehler, Hutton's new senior vice president of treasury operations and a noted cash management authority. "If the banks won't sign agreements permitting this, it will totally change the nature of treasury management."

In point of fact, the disclosure requirements set forth in the Hutton injunction could force a major restructuring of the business relationship between cash managers and their banks. The agreement for a company to compensate its bank through minimum target balances, not fees, has always been an informal, unwritten and imprecise one for a reason: The banks want it that way. As Ken Parkinson, president of New Jersey consultants Treasury Communications, puts it, "The difficulty of costing out services in order to come up with a formal bank–customer contract is the main reason banks have resisted explicit fee-based relationships in the past." This is especially true of the nation's smaller banks — which form the base of the pyramid in many sprawling collection networks and which, say the experts, would probably balk at signing formal agreements. As Sempier of Chubb puts it, these banks "don't have the mechanisms to keep track of their exposures and costs and therefore can't deal with a contractual, formal agreement." Indeed, the slow, painstaking process of getting written target-balancing agreements from its approximately 465 banks is probably costing Hutton "hundreds of thousands of dollars a month in overcompensation," Beehler believes.

Even if banks agree to formal contracts with their corporate customers, the process of negotiating the agreements is bound to make bank–corporation relationships more rigid — especially if, as will likely be the case, it involves unbundling, or an itemization of each cash management service. "This tit-for-tat environment would be a tedious world to work in," sighs Jeffrey Zeitlin, the assistant treasurer at American Hoechst, whose responsibilities include cash management. And for cash managers *and* their banks, it could present a logistical nightmare as well. "Setting an agreed-upon target balance is *ludicrous*," fumes Zeitlin. "What period of time do you set for the contract — one year? Five years? Twenty years? What forecast do you use to determine costs? Can a bank change the agreement unilaterally when its costs go up?"

Two more cash management techniques are addressed in the civil injunction against Hutton and are now, under certain circumstances, grounds for a Justice Department investigation. One is "chaining" (the second criminal practice at Hutton), a complex scheme to successively pool deposit checks from different branches around the country and write bigger and bigger checks against each deposit in order to increase the odds of earning more interest from float created in the Federal Reserve clearing system. The second is check crossing, a technique for inflating a company's next-day opening balances by simultaneously issuing checks in identical amounts drawn on two different banks and cross-depositing each check in the other bank. But cash management experts say that neither practice is widespread — partly because the Fed in recent years tightened up on the amount of float in its clearing system — and they are thus of less concern to most corporations.

The same cannot be said of the last tenet in the injunction, which prosecutor Murray admits is "an overall umbrella clause to encompass any intentional activity of cash managers that may create float or even extend it." The provision forbids Hutton — and, again by extension, all cash managers — from "creating float by retarding, delaying or obstructing the clearing of checks deposited in [Hutton's] branch or regional depository banks other than by way of stop orders, directions not to pay or other credit-related techniques."

Umbrella charge

In narrow terms, this tenet deals with what the Justice Department saw as delaying tactics on the collection side of Hutton's cash management system. But Justice Department officials, including prosecutor Murray, made it abundantly clear in extensive interviews with *Institutional Investor* that they had in mind a far wider range of what the department has concluded are abuses on the disbursement side of cash management. These practices, in Murray's words, could "be interpreted to be covered under this overall umbrella."

One technique for delaying the clearing of disbursement checks, and thus extending float, is to tamper with the micro-encoding line on the checks, causing them to be kicked out of a bank's automatic processing system and thus giving the corporation the benefit of the delays when the checks are processed by hand. Observes Murray incredulously, in a statement that accurately sums up Justice's evolving view of many common cash management practices: "I read an article in one cash man-

> **"We're telling corporate America that these practices are unacceptable, and if you continue to use them, we may be knocking on your door."**

agement trade publication that listed everything from bending the corners to putting staples in the micro-encoding line to putting Vaseline on certain parts of the check. Corporations would *do* that!"

Federal law enforcers, now alert to the lengths to which cash managers will go to delay the payment of checks, say they will be scrutinizing many gray areas here as well. In the Hutton case, for example, Justice discovered that poor-quality check printing caused problems with the banks' micro-encoders on at least three occasions. Earlier this year Bank of America complained that almost 50 percent of Hutton's checks were being rejected, compared with a normal proportion of about 1 percent. Whether or not this was an unwitting advantage that could be blamed on Hutton's overly thrifty purchasing department, the firm suffered acute embarrassment when the information became public. In its civil injunction against Hutton, the Justice Department is telling other cash managers that such "gray areas" of check-clearing delays are now fair game for federal investigators.

Of far greater concern to cash managers, the Hutton case has focused regulators' attention on the thin line separating *controlled* disbursement — a common and perfectly legitimate technique to help companies manage their cash flows — and *remote* disbursement — a game that creates disbursement float by delaying the check-clearing process, either by selecting out-of-the-way payment banks or by actually slowing up the funding of disbursement accounts.

In recent years the Fed has frowned on remote disbursement. But the area between the two has, until now, remained tricky and ungoverned territory, ripe for exploitation by the savvy cash manager. The Justice Department has made it plain, however, that the practice is now, in the words of prosecutor Murray, "ripe for a crackdown" and that government prosecutors are not afraid to venture in. As Murray puts it, "Float-extending disbursement techniques, as the banks or the creditors suffer a delay in getting their funds, can be construed as a scheme to defraud, under certain circumstances."

Proving intent

The problem, of course, is defining "circumstances." What it boils down to, in the eyes of the Justice Department, is intent: Cash managers who use out-of-the-way disbursement points strictly to manage cash flows are on the right side of the law. And properly practiced controlled disbursement is just that. By locating his main payment banks away from a money center, in areas where the Federal Reserve presents checks only once or twice a day for collection, a cash manager can know by noon each day the exact amount of disbursement checks he needs to fund. Virtually all major banks offer controlled disbursement facilities, many of them through affiliates based in upstate New York or in Delaware, and cash managers who limit their disbursement networks to these banks are probably safe from Justice Department scrutiny.

But when controlled disbursement begins to look like yet another tricky game to create float, it strays over the line into remote disbursement and a cash manager has ventured into what Murray describes as a "*dark* gray area." That would be true, for example, if a company has located its disbursement points in remote areas of the country, as far away from its creditors' banks as possible. And that is precisely the way the Justice Department now defines several services now being hawked to cash managers by banks and third-party service companies. One such device is the Troy printer, produced by the Troy division of Data Card Corp. The printer's optical reader monitors each vendor's address as bills come in; it then uses tables sold by Chicago consultant Phoenix-Hecht to determine the best combination of zip-code location and disbursement bank for delaying payment of that item. Indeed, many banks actively advertise their appeal as slow clearers. "If a bank pops up as a great disbursement point on Phoenix-Hecht, then they really beat down your door," says cash management consultant Parkinson. "If they get extra days, they offer to split the difference with you."

In the past, many major banks have also pushed cash management services called "disbursement networks," which are package deals designed to implement the same catch-as-catch-can payment game by consistently paying suppliers from the slowest clearing point in the network. Some of them, such as Irving Trust Co. and Chase Manhattan Bank, have discontinued the product. But recently, there have been some key new entrants into the field — notably Security Pacific Bank's disbursement network introduced within the last six months. "Security Pacific wants to attract payables business, and they see this as a marketing ploy," says one consultant. Generally, compensation for services like these is fixed as an increment, usually about 10 percent, of the float profits they generate.

But remote disbursement need not involve far-flung payment networks; the Justice Department views *any* technique that builds a float-creating time lag into the funding of a company's payments suspiciously as well. Such seems to be the case with another common cash management technique: covering zero-balance disbursement checks, not with cash wired from the concentration account, but with other checks. This technique obviously gives the cash manager the use of an extra day's float while the check goes through the clearing process and the money is not available to the creditor.

NBG's Fulmer emphasizes that if companies are covering their disbursement checks with other checks, they are practicing remote disbursement — unless they are paying their banks for a backup line of credit. Without these lines, it would be hard to defend themselves, post-Hutton, against charges of fraud. In fact, adds Fulmer, "Banks that are letting their customers cover disbursement checks with other checks and are offering this without proper documentation or provisional lines of credit are probably operating outside the remote disbursement guidelines set by the Federal Reserve in 1979" — which were never strongly enforced. And now, says the Justice Department, they are also operating outside the law.

Indeed, the large money center banks may well balk at signing the formal agreements now required by Justice if they offer what are now being scrutinized as questionable disbursing services. "All banks will need to look closely at services they offer to ensure that they're adequately described, both in terms of deliverability and from a legal point of view," warns Kenneth Soldwedel, vice president and manager of treasury services at Irving Trust. At any rate, says Phoenix-Hecht's Marks, a clear result of the Hutton case will be to drive home to the banks the fact that they "have no business to pay down an uncollected balance unless they treat it like a loan and charge for it. For years, I've been trying to convince them that a Hutton was bound to happen — that someday someone was going to take advantage of banks' willingness to pay down uncollected funds and their unwillingness to call the customer and ask for reimbursements."

There are already signs that the banks are taking the Hutton case to heart and, in the words of the CMA's Carter, treating overdrafts as a "form of lending." First National Bank of Chicago and several other money center banks are reportedly planning to start charging interest on overdrafts that companies have during daylight hours and that until now have been free money for corporations. "Nobody charges for these exposures now, but within five years I'd bet a substantial number will do so," says Irving Trust's Soldwedel. Other banks have begun charging fees for float items — checks in the process of clearing on their books — that exceed a certain level, such as 100 percent of collected balances. And Wells Fargo Bank and Crocker National Bank, among others, are reportedly changing their long-standing policy of analyzing average balances on a monthly basis and instead are now charging for overdrafts on the basis of day-by-day averages; the old practice inadvertently allowed the customer

> "The big worry is that Washington doesn't understand what the system is about."

to borrow intramonth in any amount he desired as long as he paid the loan back by returning the principal for a like period.

Cash managers are starting to complain, however, that the banks are generally charging a much higher rate of interest for extending funds to cover overdrafts than they *credit* to customers for excess balances left on deposit to cover services — a spread that is sometimes several hundred basis points to the banks' advantage. And, indeed, many cash managers feel that an ironic effect of the Hutton case has been to shift the balance in bank–customer relations even more in favor of the banks. Grumbles one cash manager, "Thanks to Hutton, the banks now have a real strategic negotiating edge."

A concrete signal that the big banks may use the Hutton case as an opportunity to negotiate harder with their clients is an internal Bank of America memo, released in the course of the Hutton investigation. "Due to the Hutton case," wrote Bank of America vice president Christopher Maloney, "we now have an opportunity to establish strict policies regarding the operation of E.F. Hutton's accounts. Their cash management practices are under judicial and regulatory scrutiny and they are on the defensive." The memo recommends that BofA follow the example of banks like Wells Fargo, Crocker and Morgan Guaranty and begin charging its customers for such services as overnight negative collected balances and "excessive float" that occurs as a result of delays in the check-clearing process. It also urges the bank to crack down on quality control of checks, to make sure that inferior printing jobs don't cause a lot of checks to be rejected by the automatic processor.

Of course, in some instances the power shift post-Hutton might be in companies' favor. American Hoechst's Zeitlin points out, for example, that under the informal compensation arrangements that prevail today, most companies leave "some slop in their bank balances" to compensate their banks for such services as occasional quote information, market opinions or unsolicited newsletters. But if, as will likely be the case, these extras are itemized in the formal agreements required in the Hutton injunction, "corporations will be a lot more selective" about paying for them, says Zeitlin.

Moreover, the heated competition among money center banks for corporate cash management business is likely to keep somewhat of a lid on how aggressively they use the Hutton case to squeeze an extra margin of profit from their customers' funds. In the end, in fact, the overall effect may be to put the corporation–bank relationship on a more businesslike basis, where, in the words of Hutton's Beehler, there will be much more explicit contracts of understanding between banks and their customers in all areas — concentration, disbursement and overall bank compensation."

A far greater worry for cash managers, of course, is what the Justice Department will do next, now that it has spent long months educating itself on cash management and drawn broad legal standards for certain practices. There's little doubt it has no plans to stop with the Hutton case. One source close to the department says that the fraud section, following up on complaints from banks, is already investigating other potential offenders, particularly in the brokerage community, where it feels the greatest potential for abuses exists. And Peter Clark, a fraud section attorney, confirms that "in the last 30 days we've received a number of complaints, especially regarding disbursement practices." Indeed, at least one banker is convinced that Justice will find the most abuses on the disbursement side of cash management, "and I think they'll find that the banks assisted it by pushing float-extending products onto customers." Concludes attorney Clark ominously: "Hutton was not the end. We may be at the beginning of the road to map out prohibitive practices."

Broad shift

But the concerns springing from the injunction against Hutton don't stop with possible Justice Department actions. Many cash management experts fear that the congressional spotlight focused on cash management for the first time in highly publicized investigations to ferret out executive wrongdoers at Hutton may eventually shift to the whole broad area of cash management practice. And, indeed, one former Fed governor told a banker recently that the Fed is concerned about what the Hutton case uncovered but is waiting to see what the Justice Department turns up before doing anything itself. "And if they uncover a general pattern of abusive activity at a number of companies," said this banker, "then obviously the ire of Congress will be raised and they'll take some action in the form of legislation — obviating the need for Fed action."

The prospect of politicians' venturing into an area so little understood that, as TIAA/CREF's Adamski puts it, "it's frightening" is obviously enough to make the blood of cash managers run cold. The fear, of course, is that in attempting to legislate practices in the arcane business of cash management, Congress will, in the words of consultant Parkinson, "outlaw practices that may not be outlawable." In other words, Congress might, in an attempt to get at specific abuses, throw a broad but unenforceable legislative net over a whole range of common business practices. As Phoenix-Hecht's Marks points out: "To outlaw overdrafts would be like outlawing cars because people might use them to speed. The big worry is that Washington doesn't understand what the system is about."

However, with Justice Department or congressional action still a matter of conjecture, a more immediate worry for cash managers is the effect the Hutton case will have on the top management of their own companies and, by extension, on their ability to perform their jobs. By requiring cash managers "to sign off on their bank relationships and facilities," comments NBG's Fulmer, the Justice Department demonstrates it has "broad concerns" about industry practice as a whole. This, in turn, "has made cash management a boardroom issue in a negative sense," as company directors focus on their own potential liability. And thus with the spotlight of both the law and their boards upon them, adds William Donoghue, head of the Cash Management Institute, "a lot of cash managers won't do things that are still legitimate — just to be conservative. For example, they might have trouble selling a new controlled disbursement point or doing periodic legitimate overdrafts."

At the very least, the Hutton case will have a major impact on what, until recently, has been a rapidly growing trend in the industry: the tendency to view cash management as a profit center (*Institutional Investor*, July 1985). For, as consultant Parkinson points out, Hutton's incentive system — which gave branch managers a 10 percent cut of the interest profits on overdrafts — provided a strong temptation to use the firm's cash management system "for manipulative purposes." As a result, says Parkinson, "people are rethinking the cash management incentive question — whether this should be a support function or a revenue generator." The profit center idea, he concludes, "faces a pretty severe uphill battle, and I think that's healthy. You should give it a lot of thought before you decide to do something like that to make sure there are controls."

There's little doubt, in fact, that in the wake of the Hutton scandal, the matter of controls over the cash management function, as well as cash management practices themselves, will increasingly be scrutinized by the top management of U.S. corporations. And while this scrutiny, as well as the uncertainties raised by the Hutton injunction, will present formidable challenges for cash managers in the coming months, in the end they could benefit as well. With the necessity now clearly spelled out for them to forge more businesslike relationships with their banks, and with their chief executives now highly sensitized to the crucial importance of their roles within their corporations, they may yet achieve a long-sought goal: cash management's final coming-of-age as a profession. ∎

SEARS, ROEBUCK AND CO.
SEARS TOWER
CHICAGO, ILLINOIS 60684

October 9, 1985

PHILIP M. KNOX, JR.
Vice President and
Corporate General Counsel

The Honorable William J. Hughes, Chairman
Subcommittee on Crime of the
House Committee on the Judiciary
United States House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Testimony before your Committee on October 3, 1985 by Arthur Andersen & Co. permitted an inference to be drawn that Dean Witter Reynolds Inc.'s cash management practices are of a questionable character. This was offensive to our Company and misleading to your Committee. The Andersen testimony implies that Dean Witter Reynolds' draft payable balance of $596 million at December 31, 1984 is suggestive of aggressive, if not improper, cash management and banking practices. Dean Witter Reynolds rejects this inaccurate impression and in the interest of fairness and clarity provides the following information.

On the date singled out by Arthur Andersen & Co. for its comparison, Dean Witter Reynolds' balance sheet showed $596 million of drafts payable. This amount included $188 million arising from routine banking transactions in zero balance bank accounts, a $398 million amount which resulted from an inadvertent repayment of bank loans and several minor items.

The zero balance bank accounts are normal banking services offered to banking customers and are paid for by a fee or compensating balances. By agreement these services permit the user to cover presented checks each day by transferring required amounts of good funds upon notification by the bank.

With respect to the $398 million amount, Dean Witter Reynolds, acting on preliminary and internally developed information at December 31, 1984 regarding the availability of funds, paid down certain bank lines of credit. On the next business day, the preliminary information was discovered to be incorrect and corrective action was immediately taken, including compensating the bank for the two-day use of funds at a rate of interest above the then prevailing bank prime rate. In addition, the New York Stock Exchange was informed of these circumstances.

Mr. HUGHES. The subcommittee stands adjourned.
[Whereupon, at 4:15 p.m., the subcommittee was adjourned.]

Drafts payable do not necessarily mean actual bank overdrafts, nor do they suggest inappropriate banking practices. In the particular instance on December 31, 1984, an actual bank overdraft was inadvertently created but promptly discovered, reported, compensated and rectified. By design, zero balance bank accounts do not create actual bank overdrafts.

Touche Ross & Co. has read this letter and concurs in our view that companies which use a zero balance banking service will incur a financial statement liability equal to the sum of the written but unpresented checks. They agree that neither the presence nor the amount of such a liability in any way suggests improper banking practices.

We would be happy to provide any additional information that might be of assistance to your Committee.

Very truly yours,

Philip M. Knox, Jr.

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E.F. HUTTON MAIL AND WIRE FRAUD CASE

THURSDAY, OCTOBER 31, 1985

House of Representatives,
Subcommittee on Crime,
Committee on the Judiciary,
Washington, DC.

The subcommittee met at 10:25 a.m., room 2141, Rayburn House Office Building, Hon. William J. Hughes (chairman of the subcommittee) presiding.

Present: Representatives Hughes, McCollum, Morrison, Gekas, Feighan, Shaw, Smith, and Mazzoli.

Staff present: Hayden Gregory, chief counsel; Virginia Sloan, assistant counsel; Eric Sterling, assistant counsel; Edward O'Connell, assistant counsel; Charlene Vanlier Heydinger, associate counsel; Fred Stuckwisch, GAO consultant; Theresa Bourgeois, staff assistant; Phyllis Henderson, clerk; Brenda Lang, staff aide; Joanne Royce, staff aide; and Franco Munúz, staff aide.

Mr. Hughes. The Subcommittee on Crime will come to order.

The Chair has received a request to cover this hearing in whole or in part by television broadcast, radio broadcast, still photography, or by other similar methods. In accordance with committee rule 5(a), permission will be granted unless there is objection.

Is there objection?

[No response.]

Hearing no objection, coverage is permitted.

Today is the fifth of the Subcommittee on Crime's hearings regarding the *E.F. Hutton* case. Pursuant to our oversight responsibility over the Justice Department, this subcommittee has embarked upon the investigation of the Justice Department's handling of a number of so-called white collar crime cases. In our first such investigation, the *E.F. Hutton* case, we intend, ultimately, to determine whether the Department properly exercised its discretion in entering into the plea bargain with Hutton, and whether the terms of that plea bargain best serve the public interest.

In order to make an informed judgment regarding the appropriateness of the Department's actions, it is critical that we learn as much as we can about what Hutton actually did and who was responsible.

As you may recall, in our first hearing on June 19 of this year, testimony was taken from senior level executives of Hutton. Our second hearing featured testimony from Hutton and the Justice Department concerning their difficulties in cooperating with our investigation. At the third hearing, we heard testimony from lower level Hutton officials who participated in the actual mechanics of the overdrafting scheme. At our most recent hearing, early this month, our focus shifted somewhat to an examination of the role of public accountants in the *Hutton* case.

Today, we return to the focus of our initial hearing, that is the knowledge and responsibilty of Hutton senior executives. Our witness is George L. Ball, who was president of E.F. Hutton during the period of Hutton's most egregious overdrafting practices. Mr. Ball resigned from Hutton in 1982, and is currently president of another brokerage firm.

The Chair at this time recognizes the gentleman from Pennsylvania, Mr. Gekas, for an opening statement.

Mr. GEKAS. Yes, thank you, Mr. Chairman.

As the chairman has stated, the ultimate purpose of these hearings is to arrive at conclusions having to do with the Justice Department's decisionmaking in this entire issue. One thing that should be made clear, though, I am hoping that we get to the crux of that as soon as possible and that the remainder of the hearings will focus on that, rather than to allow the cloud to linger over the Hutton employees who, for the most part, there being thousands of them, are innocent of anything having to do with any of the things we're examining.

So, I'm praying that we get to the meat of the matter, our oversight responsibilities into the Justice Department's part in this issue, as quickly as possible. With that, we're not going to overlook the testimony that has already been rendered and to try to get a handle on how all of this occurred, but I just want the public to know that we are interested not in having the thousands of employees continue the agony of seeing their company undergoing these tribulations.

As far as I am concerned, part of the justice that has to be rendered in this case has already been rendered; let's get on with it.

I thank the chairman.

Mr. HUGHES. Well, I just want to say to the gentleman from Pennsylvania that I share his concern. We should have completed these E.F. Hutton hearings about 2 months ago. And as of today, we still haven't received all of the documents from E.F. Hutton or the Justice Department.

I met with Warren Christopher last week, and E.F. Hutton has claimed executive privilege on a number of documents that they've turned over to Griffin Bell and made available to others within the company that we have not gained access to. The Justice Department has, to date, not furnished us with anywhere near the documentation that we've asked for. They continue to exercise the right, under 6(c), to deny us documents.

I scheduled a meeting of the committee for next week, so that we can decide what we want to do about the Justice Department's stonewalling on documents.

I say to the gentleman, we don't even have a complete account of the zero balance account, which is the special account in New York, in which we can make an effort to reconstruct exactly what occurred. So, I think the gentleman understands that we can't possibly complete our investigation unless we find out, first of all, what went on; and that has been our endeavor.

Mr. GEKAS. Will the chairman yield?

Mr. **Hughes**. Be happy to yield.

Mr. **Gekas**. I have no quarrel with the problems as the chairman sees them and the need to overcome them, I am simply saying that as quickly as we can go to that, the better it is. I'm concerned about the employees, the innocent employees of Hutton.

Mr. **Hughes**. I quite agree. I say to the gentleman: we have a money laundering bill, a major money laundering bill that we want to move; we've embarked upon some hearings about guns which drew more heat than light; we're endeavoring to move legislation dealing with radiograms for the Coast Guard to try to clear up some problems there; we've got a rewards bill that is backed up. So, I share the gentleman's concern. And we have a number of other white collar crime cases we can't get to because of the stonewalling that is involved in this case.

And as I indicated at the outset, we're going to get all the documents we need to complete this investigation. We're going to get them either voluntarily or we're going to get them by subpoena; and that's what we're endeavoring to do right now. But until we have all the documents, we can't move ahead and complete the investigation.

Mr. **Gekas**. Mr. Chairman, but a point of information, if you would yield to me again.

Mr. **Hughes**. Be happy to yield.

Mr. **Gekas**. Have we tried to get access to the court avenue of getting these documents? Have we completed that endeavor there?

Mr. **Hughes**. The gentleman is asking whether or not we've endeavored to go into court. That is not the procedure, as I see, that we would have to follow.

The procedure, I believe, to protect the rights of this institution to certain evidence is to subpoena the documents; for failure to provide those documents, to go the route of citation for contempt. That's the route, in my judgment, that is the proper route for this institution to take. We asked for documents, in my judgment, that are not covered by 6(e), and we're not getting them.

Mr. **Gekas**. The only question I have is if we should try everything as fast as possible.

Mr. **Hughes**. Well, next week the gentleman will have an opportunity in committee, either in executive session or in open session, to decide what we want to do about some of the stonewalling.

Mr. **Smith**. Will the chairman yield?

Mr. **Hughes**. Be happy to yield to the gentleman from Florida.

Mr. **Smith**. I appreciate the concern shown by the gentleman from Pennsylvania, but I want to make something I think that is a point that all of us share as frustration. He raised the issue of the employees of Hutton; if this were such a concern, it should have been made by the company, E.F. Hutton, in the first instance. They should be concerned about their employees.

Obviously, everybody is having a problem finishing this matter, and I think it is encumbent upon them to produce the kinds of documentation that has been requested. To some degree it is a slap in the face to this committee and this Congress that both E.F. Hutton and the Justice Department refuse to cooperate to a significant extent to get this thing done. You and I both share the desire to terminate these hearings, come up with a conclusion and issue a report and move on to the other issues that we have.

Mr. HUGHES. Well, I don't want to prolong this, because we have a witness that we want to call.

Let me just say that Warren Christopher came on board about a month and a half ago, and since that time we've seen major progress. If we had seen that kind of progress 3 months ago, 3½ months ago, we would have much of what we don't have behind us.

At this time I wonder if our witness, Mr. Ball, would come forward.

Mr. Ball, pursuant to clause 1 of rule XI and clause 1 of rule X of the House of Representatives, this hearing of the Subcommittee on Crime of the Committee on the Judiciary is an oversight investigation of the E.F. Hutton mail and wire fraud case.

Let the record indicate that pursuant to clause 2 of rule XI of the Rules of the House of Representatives, copies of the Rules of the Committee on the Judiciary and of clause 2 of rule XI of the House have been made available to the witness and are available at the witness table.

Mr. Ball, you have a right to have counsel to assist you in the course of this morning's proceedings.

Are you accompanied by counsel?

Mr. BALL. Yes, I am.

Mr. HUGHES. I wonder if counsel will indicate for the record his identity for us.

Mr. CUTLER. My name is Lloyd N. Cutler, and I am here as counsel for Mr. Ball.

Mr. HUGHES. Thank you.

Mr. Ball, I am going to place you under oath at this time. Will you please raise your right hand.

[Witness sworn.]

You may be seated.

Mr. Ball, we have your statement which you furnished to us in advance, and we appreciate that. It is a rather short statement. And you may proceed as you see fit. It will be made a part of the record without objection.

TESTIMONY OF GEORGE L. BALL, FORMER PRESIDENT OF E.F. HUTTON, ACCOMPANIED BY LLOYD N. CUTLER, ESQUIRE

Mr. BALL. Thank you, Mr. Chairman and members of the subcommittee. I welcome the opportunity to answer your questions this morning concerning E.F. Hutton's cash management practices during the time I was associated with that firm.

As you may well know, I became president of E.F. Hutton in 1977, having been its national retail sales manager for the preceding 7 years. I left Hutton in July 1982.

While president of Hutton, my responsibilities continued to be primarily those of the management of the retail sales function. In other words, I was not the firm's chief operating officer. Like a number of other senior Hutton officers, I reported directly to Robert Fomon, who was chairman and chief executive officer. The others reporting directly to Mr. Fomon included the chief financial officer, the head of operations, and the company's general counsel;

each of whose functions have been integral to your inquiry. In addition, the heads of the corporate finance, public finance, and trading departments also reported directly to Mr. Fomon.

I mention this to underscore the diffuse nature of Hutton's management structure, in order to provide you with a better understanding of its corporate system. That does not mean to suggest that I was a minor figure in the company. To the contrary, the retail sales force which reported to me consisted of over 4000 account executives and generated revenues of over $1 billion a year at the time I left Hutton in 1982.

During my tenure at Hutton, my knowledge of the drawdown system was rudimentary. I was not aware of any improprieties in the conduct of that system until July 1982; excuse me, until February 1982. At that juncture Mr. Fomon informed me that a problem had been brought to his attention by counsel that he, Mr. Fomon, had told them to remedy the situation. Even thereafter, I was not included in meetings relating to the drawdown system problems or possible modifications to that system. In other words, simply put, I had no knowledge of, nor responsibility for, the deficiencies in Hutton's control mechanisms that resulted in the abuse of its cash management system.

I was, of course, aware that the firm had a cash management system, one designed to bring money from its branches to its headquarters as quickly as possible and to minimize the loss of interest on float to banks. I was also aware that this system utilized overdrafting against uncleared check deposits as a means to reduce the loss of float. I was not aware of the procedures or specific methods used to reach that result. I was certainly not aware that some regions and branches were abusing the system in order to generate additional interest income by excessive overdrafting or chaining.

As you well know, I think, I was a prolific memo and note writer, and consistently encouraged employees to achieve excellence in their work. In my experience, there is no sales person, no manager, no worker, who has reached the maximum of his or her abilities. That is true at Hutton and elsewhere. However, one should not mistake a search for improvement for willingness to cut corners. Exhorting branches to increase their interest profits or stock sales or cost effectiveness, was in no way a call for sharp practices.

To the contrary, on several occasions in the course of reviewing the financial results of the branches, I sent memoranda to my colleagues asking questions about branch profit margins and interest income that appeared unusually high. In some cases those memos related to branches that, according to Judge Bell's recent report, were exonerated from any responsibility for abusive practices. In other instances, the memorandum did relate to branches that, according, again, to Judge Bell's report, were engaged in wrongful actions. At no time did I receive a reply indicating any impropriety.

Mr. Chairman, thank you, and I would be pleased to answer any questions that the committee has.

[The statement of Mr. Ball follows:]

PREPARED STATEMENT OF GEORGE M. BALL

Thank you, Mr. Chairman and Members of the Subcommittee:

I welcome the opportunity you afford me to answer your questions this morning concerning E.F. Hutton's cash management practices during the time I was associated with that firm.

As you may know, I became president of E.F. Hutton in 1977, having been its national retail sales manager for the preceding seven years. I left E.F. Hutton in July, 1982.

While I was president of E.F. Hutton, my responsibilities continued to be primarily those of the management of the retail sales function. I was not the firm's chief operating officer. Like a number of other senior Hutton officers, I reported directly to Robert M. Fomon, chairman and chief executive officer. Those others reporting directly to him included the chief financial officer, the head of operations and the company's general counsel, each of whose functions have been integral to your inquiry. In addition, the head of the corporate finance, public finance and trading also reported directly to Mr. Fomon.

I underscore the diffuse nature of Hutton's management structure to provide you with a better understanding of its corporate system without attempting to suggest I was a minor figure in the company. To the contrary the retail sales force which reported to me consisted of over 4,000 account executives and generated revenues of over one billion dollars a year by the time I left Hutton in July 1982.

During my tenure at Hutton, my knowledge of the drawdown system was sketchy at best. I was not aware of any improprieties in its drawdown system until February, 1982, when Mr. Fomon informed me that a problem had been brought to his attention by counsel and that he had told them to remedy the situation. Even thereafter, I was not included in meetings relating to drawdown system problems or possible modifications to that system. Simply put, I had no knowledge of, nor responsibility for, the deficiencies in Hutton's control mechanisms that resulted in the abuse of its cash management system.

I was of course aware that the firm had a cash management system designed to bring money from its branches to its headquarters as quickly as possible to minimize the loss of interest on float to banks. I was also aware that this system utilized overdrafting against uncleared check deposits as a means to reduce the loss of float. I was not aware of the procedures or specific methods used to reach that result. I certainly was also not aware that some regions and branches were abusing that system in order to generate additional interest income by excessive overdrafting or chaining.

As you know, I was a prolific memo and note writer, and consistently encouraged employees to achieve excellence in each aspect of their work. In my experience, there is no sales person, no manger, no worker, who has reached the maximum of his or her abilities. That is true at Hutton and elsewhere. However, one should not mistake a search for improvement for a willingness to cut corners. Exhorting branches to increase their interest profits or stock sales or cost effectiveness, was in no way a call for sharp practices.

To the contrary, on several occasions in the course of reviewing the financial results of the branches, I sent memoranda to my colleagues asking questions about branch profit margins and interest income that appeared unusually high. In some cases the memos related to branches that, according to Judge Bell's recent report, he exonerated from any responsibility for abusive practices. In other cases, the memoranda related to branches that, according to Judge Bell's report, did engage in abuse actions. At no time did I receive a reply indicating any impropriety.

Mr. Chairman, I would be pleased to answer any questions that the Committee may wish to ask.

Mr. HUGHES. I want to try to adhere to the 5-minute rule, and we'll take as many rounds as we need to take.

First, thank you, Mr. Ball, for your testimony.

As president of E.F. Hutton, who did you report to?

Mr. BALL. I reported to Mr. Fomon, the chairman and chief executive, Mr. Chairman.

Mr. HUGHES. I see.

And who reported to you, both directly and indirectly?

Mr. BALL. Those reporting to me were: the regional vice presidents of E.F. Hutton, of whom there were 9 or 10; the director of the retail marketing organization; at various times certain of the marketing departments that supported the retail area such as the

Tax Shelter Department, the Municipal Bond Liaison Department, and the like; Hutton's director of research; and, after Hutton acquired it, the head of the E.F. Hutton Life Insurance Co.

Mr. HUGHES. And would you describe in a little more detail for us—you did touch upon it—your responsibilities as president of the brokerage firm.

Mr. BALL. My responsibilities as president of E.F. Hutton and the E.F. Hutton structures as opposed to anybody else's, were to see that the branch network generated revenues, was cost effective, and that it was properly supported by product and idea flows that would be of benefit to it.

Again, the mechanism for doing that was via the 10 regions of Hutton, who had regional vice presidents who reported to me.

Mr. HUGHES. And would it be correct to say that part of your job was to see that your various regions maximized their profits?

Mr. BALL. Yes. One of my tasks was to see that the results of Hutton were optimized. And I would differentiate just a bit from maximize in that sense: in a very slow market one cannot maximize profits, one can only optimize them relative to the environment that exists within the investment world.

Mr. HUGHES. But one of your primary functions was to see that E.F. Hutton was profitable.

Mr. BALL. Yes, sir. And as with any corporate executive, I was not only responsible for, but should have been responsible for, seeing that Hutton's profits were as high as possible within every proper and legitimate means. And here, of course, I'm underscoring "proper and legitimate" as opposed to things that would be done in a corner-cutting or underhanded way.

I do think, if I could just add, Mr. Chairman, that within the conduct of Hutton not only by me but by others, given the frailties of mankind and leaving the money management wrongdoings aside for the moment, that that firm did both a fine job of operating profitably and doing it in a way that was honorable and good.

Mr. HUGHES. Were you also director of both the brokerage firm and the holding company?

Mr. BALL. Yes, I was, sir.

Mr. HUGHES. When did you become a director of each?

Mr. BALL. I believe that I became a director of both E.F. Hutton Group and E.F. Hutton, Inc., the broker-dealer, simultaneously; and my guess is that that would be 1972, or 1973, or 1974, Mr. Chairman, but I am not certain about the exact date. It was while I was still national retail sales manager and before I became president.

Mr. HUGHES. Was it your responsibility to sign off on the hiring of any new employees?

Mr. BALL. Well, if by the word "any" you mean every, certainly not; if by "any" you mean those who were at a relatively senior level and reporting to me, in many cases I would sign off.

Mr. HUGHES. How about those that would be in other areas: lesser employees, employees——

Mr. BALL. Could you give me an example, sir?

Mr. HUGHES. Such as messengers.

Mr. BALL. No. As a general rule I would not sign off on the hiring of messengers. I may have on one occasion, but I'm not——

Mr. **HUGHES**. I'm not being facetious, I'm just asking, I'm just trying to find out the extent of your responsibility.

Would you be consulted if an additional messenger were needed?

Mr. **BALL**. No; not if an additional messenger was needed, no.

Again, there may have been a case when that happened, but as a general rule, if that is what you are asking about, certainly not.

Mr. **HUGHES**. Well, I'm going to ask if you are familiar with a memorandum dated February 8, 1982, directed to you, George Ball, from Alan J. Miller.

I offer it for the record. Without objection?

So received.

[The document referred to follows:]

FEBRUARY 8, 1982.

To: George Ball.
From: Alan J. Miller.
Subject: HIM Messenger.

Hutton Investment Management will require its own messenger when we move to 71 Broadway—we had been sharing a messenger with the Research Department.

I understand that you must approve all additions to staff. Would you please OK our hiring a messenger for HIM?

Alan—Under the circumstances, not yet. Let the messenger cover both. Shouldn't he be able to do so?

GEORGE.

Mr. **HUGHES**. It says: "Hutton Investment Management will require its own messenger when we move to 71 Broadway—we had been sharing a messenger with the Research Department.

"I understand that you must approve all additions to staff. Would you please OK our hiring a messenger for HIM?"

And it looks like your writing, a note which says:

"Alan, under the circumstances, let the messenger cover both. Shouldn't he be able to do so?

"George."

Mr. **BALL**. Mr. Chairman, I don't seem to have a copy of that. Was that——

Mr. **HUGHES**. We'll circulate them. Here it is.

Are you familiar with that memorandum?

Mr. **BALL**. I do not recall having seen it. I can understand it, and do see my writing on it, certainly, Mr. Chairman. Yes.

Mr. **HUGHES**. Well, that would suggest to me that you did reach down to approve even the hiring of messengers, and that that was the perception, that it had to be cleared through you.

Mr. **BALL**. Mr. Chairman, I'm not certain of the statement I am about to make, but let me offer it anyhow by serious means of trying to be helpful: I believe that at or about this point in time E.F. Hutton had a program of no adds to staff; one could not add people without the approval of one of the senior officers who reported directly to Mr. Fomon—myself, or the head of operations, if it were an operations employee, or the like. And, so, I think it probably was within that context that I was asked to approve—but again, as a general rule did I approve hiring messengers? No. During a period when Hutton was—and, again, this is from memory as opposed to specific—I think in a no-add-to-staff mode, that would be quite different. But yes, in this case, I did approve the hiring of a messenger; I'm not trying to gainsay that.

Mr. Hughes. Well, my time has expired, and the Chair recognizes the gentleman from Pennsylvania for 5 minutes.

Mr. Gekas. I have no questions at this time. I reserve the right to ask at the end.

Mr. Hughes. The chair recognizes the gentleman from Connecticut, Mr. Morrison.

Mr. Morrison. Thank you, Mr. Chairman.

Mr. Ball, could you explain who it was that did report to you within the structure, and who, in the top—what part of the top management did not report to you?

Mr. Ball. Yes, sir.

Should I start, Congressman, with those who did report to me?

Mr. Morrison. Well, I would like to be clear, because in your earlier description you indicated a certain part of the business was your responsibility, but I would like a little more clarity as to, in the top operating departments, who was it that reported to you and who were the people who did not.

Mr. Ball. Those who did report to me, on the affirmative side, were: the—I believe it was either nine or ten regional vice presidents. They—and those were divided geographically: New England Region, Atlantic Region, the Southeast Region, et cetera. The head of the research department reported to me. The head of the retail marketing organization—the tax shelters, mutual funds, over-the-counter liaison, marketing—reported to me. And the head of the—and this is probably extraneous to it, but just for the sake of thoroughness, Congressman, the head of the E.F. Hutton Life Insurance Co. also reported to me.

Those who did not report to me were: the head of the corporate finance department, head of the public finance department, head of the trading departments—which, I think again, are largely extraneous to this particular investigation and inquiry.

Neither did the heads of the operations department, the accounting department, the administrative department, the legal department, or the commodities department report to me. Each of those reported directly to Mr. Fomon.

Mr. Morrison. Now, you reported to Mr. Fomon?

Mr. Ball. Pardon, sir?

Mr. Morrison. You reported to Mr. Fomon?

Mr. Ball. Yes. I was one of, let me say, seven of eight people who reported directly to Mr. Fomon.

Mr. Morrison. So you, and the comptroller, and the general counsel, all of these people, were of equal rank?

Mr. Ball. I did not say the comptroller, per se.

Shall I do it once more in terms of those who did not report to me and their rank equivalency with me?

Mr. Morrison. Well, who was it that—there were a number of other people who reported directly to Mr. Fomon, and you reported directly to Mr. Fomon.

Mr. Ball. Correct, sir.

Mr. Morrison. And were you all perceived to have the same level of responsibility?

It seems like a rather strange structure.

Mr. **Ball**. I was certainly the senior sales officer of the firm. I had people reporting to me who, as regional vice presidents, were very senior within the firm.

At a guess—and this is a guess, Congressman—70 percent of E.F. Hutton's revenues came from its retail force; so, although there were a number of other people who reported directly to Mr. Fomon, and who, to that degree, were certainly pari passu with me, the bulk of the revenue stream reported to individuals who reported to me.

Mr. Epstein ran the operations department: He reported directly to Mr. Fomon. Mr Hines ran the corporate planning and the accounting departments: He reported directly to Mr. Fomon. Mr. Lynch was the chief financial officer—I think without that title, but with that function and the administrative function of the Hutton Corp., reporting directly to Mr. Fomon. The head of the commodities department reported directly to Mr. Fomon. And Mr. Rae, who had the legal department and also internal audit reporting to him, reported to Mr. Fomon. So, from a reporting standpoint, we were certainly equals; in terms of the revenue content of the firm, I had the majority of it in my purview.

Mr. **Morrison**. Well, who in that structure had responsibility for cash management activities when you were there?

Mr. **Ball**. The cash management activities were directed not by any of the people who I have mentioned but by the money mobilization department. That was run by Mr. Morley.

Mr. **Morrison**. And who did Mr. Morley report to?

Mr. **Ball**. He reported to a gentleman named Bob Ross, who was the—I believe it had the title of cashier of——

Mr. **Morrison**. But who, of the people that you've named earlier? Was this Mr. Lynch's responsibility?

Mr. **Ball**. I believe that Mr. Ross reported to Mr. Epstein. I am not sure, from a functional standpoint, whether, as it relates to cash management activities, the reporting relationship ran from Mr. Morley, to Mr. Ross, to Mr. Epstein, or Mr. Morley, to Mr. Ross, to Mr. Lynch; I don't know.

Mr. **Morrison**. Were you involved at all in setting up this structure, as to where the cash management responsibility would lie?

Mr. **Ball**. Not at all, Congressman, no.

Mr. **Morrison**. I mean, did that exist prior to your becoming president?

Mr. **Ball**. It existed prior to my becoming president. There was someone hired—Mr. Morley was hired after I became president, but not hired or interviewed by me. And I was not involved in the discussions, nor, as you can tell, was I really aware—nor am I aware—of exactly to whom the money mobilization function did report.

I know that on—I have seen a chart that says that Mr. Morley reported to Mr. Ross, and then, as to the responsibility for the cash management side, I don't know if it ran to Mr. Epstein or to Mr. Lynch.

Mr. **Morrison**. But the profitability of the sales offices under your responsibility was very much related to its handling of cash, that was an important part of the profitability of those offices; is that right?

Mr. **Ball**. It was a part—Congressman, I would differ a bit by saying it was a small part. But it was certainly a part, and I don't want to gainsay that.

Mr. **Morrison**. Well, I think in a little bit we'll get into some memos in which you emphasize it quite frequently in rating offices on a month-to-month basis, so it was something you paid attention to.

Mr. **Ball**. Yes, sir. And the interest profit of Hutton overall and of the branches—the branches being, as I say, a key component of Hutton's overall results—became more and more important as interest rates in the economy arose.

In other words, when interest rates were 2 or 3 percent, interest profit which is derived from a great variety of sources, one of which is drawing money down to minimize Hutton's interest expense but is derived from many sources, the interest profit became more important as——

Mr. **Morrison**. It was an important part, but you are saying that you had no direct involvement in who, or what was running the cash management system.

Mr. **Ball**. That is correct, sir. Yes.

Mr. **Morrison**. My time has expired.

Mr. **Hughes**. The Chair recognizes the gentleman from Florida for 5 minutes.

Mr. **Shaw**. Mr. Chairman, we had, at an earlier meeting, the people at E.F. Hutton to supply us with a chart setting forth the organizational structure of the company. I would like to hand that to Mr. Ball, and at this time I would ask unanimous consent to put it in the record of this hearing, because I want him to comment on this.

Mr. **Hughes**. Without objection, so ordered.

[The document referred to follows:]

EXECUTIVE ORGANIZATION

R. Fomon, Chairman and CEO; George Ball, President, E.F. Hutton Group, E.F. Hutton & Co., Inc.									
J. Lopp (EVP)	R. Locke (EVP)	P. Hines (EVP) [1]	T. Rae (EVP)	T.P. Lynch (EVP)	J. Gahan (EVP)	N. Epstein (EVP) [1]	J. Daly (EVP)	J. Goldsmith (EVP)	Domestic sales regions [1]
Corporate finance	Public finance, S. Pierce.	Control, M. Castellanc. Corporate development, H. Wellisch, I. Broad. Hutton financial services & national ins. mrkting., R. Filderman. Hutton venture investment partners.	Corp. counsel .... Legal & compliance, L. Schecter. Internal audit, M. Pepper.	Corp. tax, J. Daffner. Corp. administration, M. Siegel.	Taxable fixed income trading, W. Dunn. OTC trading, P. Yednak.	Branch managers—. Marketing, P. Muratore. Customer Service, R. Eber. International branches, P. Riedener. Research department. Operations/sales .... Communications .... EDP .... Cashiering .... Trading operations, R. Genin.	Commodities operations. Sales	Inst. equity sales and block trading.	Atlantic, J. Miller Central, J. Latshaw Midwest, A. Doree Mountain, D. Frey No. East, R. Witt Pac. No., T. Belshe Pac. So., H. Kawahara So. Central, M. Judd So. East, R. Williams

(1) Organizational details attached.
Source: Prepared on June 21, 1985 as of December 31, 1981.

Mr. **Shaw**. Mr. Ball, could you examine the sheet of paper we've just handed you?

And I don't know, have you ever seen this before?

You may very well not have, because it was supplied to us, having been, it appears, June 21, 1985, as a draft.

Mr. **Ball**. I have not seen it before. I am looking at it now, Congressman, yes.

Mr. **Shaw**. Would you comment on the chart, making——

Mr. **Hughes**. Why doesn't the witness take just a few minutes and just take a close look at it. It is important that you understand it.

Mr. **Shaw**. For the benefit of the members, the chart that I'm referring to is at the very—I think it is in the back of your briefing book.

[Pause.]

Mr. **Ball**. I have reviewed the chart now, Congressman, yes.

Mr. **Shaw**. And without being bound by every pencil mark on there, do you think it fairly sets forth what the organization of E.F. Hutton was at the time we've been questioning you about?

Mr. **Ball**. No. There is a chart that is one of the exhibits in Judge Bell's report, that I think is exhibit 21 in that, that really, to me, exemplifies what the E.F. Hutton reporting relationships were during my tenure as president. To the extent that this chart has dotted lines of a lot of people reporting to me and to Mr. Fomon, I don't believe that that is accurate, nor, from what I have heard, as Hutton set that forth as being the actual set of relationships that existed in 1977 until 1982.

I believe, if the people shown as reporting—as being the head of the public finance, the control, the corporate counsel, the tax, the trading, the operations, commodities and institutional sales areas were asked to whom they reported, they would say they reported to Mr. Fomon. I think Mr. Fomon would say the same thing, although I clearly have not asked him about it, Congressman.

Mr. **Shaw**. We've heard approximately the same thing, I don't think that contradicts. As a matter of fact, I think one thing that this organizational chart does set forth, and that is that the responsibility was pretty loose. I think that is probably one of the problems that this committee has had in order to try to pinpoint responsibility during this whole matter.

Did Epstein—you're telling the committee that Epstein reported to Fomon and not to you at all?

Mr. **Ball**. That is correct, sir.

Mr. **Shaw**. What contact did you have with him?

Mr. **Ball**. I spoke with Mr. Epstein frequently, because the effectiveness of an operations department which processes trades and orders clearly is very important to the successful function of a branch office. If you can't get your orders in and executed and back and produce an accurate customer statement, you've got a debacle, and so when things went wrong, or when there was an improvement suggested, I would talk with Mr. Epstein, say, "Norm, can you fix x, y, or z?" But in terms of a reporting relationship—and I don't know if Mr. Epstein has been asked this question, Congressman, but I think he would clearly say, as with Mr. Fomon, he reported to Bob Fomon and not to me.

Mr. SHAW. And was the money mobilizer under him? Was that area of his responsibility?

Mr. BALL. Congressman, as I noted when asked this sort of question before, the money mobilizer reported to Mr. Ross, that I know. Mr. Ross——

Mr. SHAW. Where would Mr. Ross appear on this chart? Is his name on here?

Mr. BALL. No. Well, let me see. Mr. Ross was head of the cashiering department, and so he shows under——

Mr. SHAW. Well, cashiering they show under Mr. Epstein.

Mr. BALL. Yes.

Mr. SHAW. Is that where it ought to be?

Mr. BALL. That is where it shows in the chart in Judge Bell's report as well as here. From a functional standpoint, in terms of who really worked for whom, I do not know if Mr. Morley, reporting to Mr. Ross and then talking with more senior people about money mobilization, reported to Mr. Lynch or Mr. Epstein.

It is just an area of which I am ignorant, and I would be wrong to set forth——

Mr. HUGHES. Would the gentleman yield to me for a moment?

Mr. SHAW. I'll be glad to yield.

Mr. HUGHES. I'm wondering if the gentleman would just take the time—and it won't come out of his time—just to try to get the witness to explain to us what is erroneous about this chart.

This was given to the subcommittee by E.F. Hutton as a chart indicating the line of responsibility, and it indicates that all these departments were, de facto, reporting to you, Mr. Ball. Why don't you go through and, if you can, tell us exactly what the differences are between the organization as you understood it as of December 31, 1981, and what appears on this chart, which was represented to this committee as the organization of the company on December 31, 1981.

Mr. BALL. Certainly, sir. As I said, the domestic sales regions and the marketing—the domestic regional retail regions and the marketing thereof, and the support therefor, did report directly to me, as I said. Those were my functions.

In the chart that you have in front of you, the corporate finance department, run by Mr. Lopp, is shown as reporting directly to Mr. Fomon; which is correct.

The public finance, the control, the corporate counsel, the administrative area, the trading area, the operations areas, the commodities areas and the institutional equity sales and block trading areas, did not report to me.

Again, I think that that is in the chart in Judge Bell's report, No. 1. And, No. 2, if you have talked to people at Hutton before, I think that would be——

Mr. HUGHES. I don't know why that gives it any authenticity, because it was in Mr. Bell's report. Mr. Bell was working for E.F. Hutton in his investigation. What is more relevant is what was the facts.

I mean, what was the organization on December 31, 1981? And if you go through and——

Because this would indicate that all the operations, that Mr. Lopp, corporate finance, Mr. Locke, Mr. Hines, Mr. Rae, Mr.

Lynch, Mr. Gahan, Mr. Epstein, Mr. Daly, Mr. Goldsmith, all, de facto, reported to you. I'm sorry, with the exception of Mr. Lopp, who reported directly to Mr. Fomon.

Isn't that what this chart indicates?

Mr. GEKAS. Would the chairman yield for moment?

Mr. HUGHES. I don't have the time, the gentleman from Florida has the time.

Mr. SHAW. I yield.

Mr. GEKAS. I'm wondering if there is any significance to the dotted line as opposed to the straight line.

Mr. HUGHES. Would the gentleman from Florida yield to me again?

Mr. SHAW. Yes, I'll be glad to yield.

Mr. HUGHES. It was explained by the company that the dotted line meant de facto reporting as opposed to the formal reporting structure, de facto reporting, that, in fact, that was the line of reporting.

Mr. GEKAS. That is what I think is important.

Mr. SHAW. I think what it appears to the committee, is that no one wanted to say any of those people were reporting to them in one way or the other. I think that is probably the basis.

Mr. CUTLER. Could I interrupt for a moment——

Mr. SHAW. Yes.

Mr. CUTLER [continuing]. To ask whether exhibit 21 to Judge Bell's report could be made a part of the record at this point, without getting into its authenticity?

Mr. HUGHES. Well, we're not going to make anything in the Bell report a part of the record at this time and point, because we don't know the authenticity of it. We have been unable to get many of the records that support some of those findings. We've asked for them, but much of them have been made unavailable to us.

Mr. CUTLER. The witness has said that his understanding of the organization is as set forth in exhibit 21 to Judge Bell's report.

Mr. HUGHES. Well, we have the Bell report and we'll use that, but we have not been able to test some of the authenticities or the source of some of the information.

Mr. BALL. Mr. Chairman, again, to speak very specifically to your point, the people cited—Mr. Locke, Mr. Hines, Mr. Rae, Mr. Lynch, Mr. Gahan, Mr. Epstein, Mr. Daly, Mr. Goldsmith—did not report to me. I did talk with them, obviously, in the course of business, and we all spoke with one another, but they did not report to me.

Mr. CUTLER. Mr. Chairman, according to this new chart, which was reconstructed 5 years later, all of those people that were mentioned, like Mr. Lynch and Mr. Epstein, didn't report to anybody, because there are only dotted lines above them.

Mr. HUGHES. As I explained to counsel, it was represented to the committee that those broken lines meant de facto reporting, that, in fact, they reported to Mr. Ball.

The gentleman from Florida still has time.

Mr. SHAW. I would like to pursue this for another few minutes, Mr. Ball, with regard to the communications that you did have with these people.

How often did you talk to Mr. Epstein and did you talk to him about the movement of money, mobilization of money? Did you discuss the amounts that were being received, were being shown as income to E.F. Hutton during this period of time?

Mr. BALL. I spoke with Mr. Epstein very frequently, Congressman. Again, since he ran the operations department, which is the whole processing plant of Hutton, its success, its failures, and important, including the EDP department, which was critical to the proper support and growth of many of Hutton's sales products, meant that I talked with Mr. Epstein on a daily basis; perhaps not that often, but let me say daily. To the very best of my recollection, I never discussed drawdown systems, cash management, the movements of money or funds with him at any time.

Mr. SHAW. Now, you mentioned—I think you said—65 percent or maybe it was greater of the income of E.F. Hutton was from the retail sales. What figure was that?

Mr. BALL. I was guessing at 70 percent, Congressman.

Mr. SHAW. Seventy percent?

Mr. BALL. And that's revenues the way Hutton keeps its books, which is all revenue items and does not include income——

Mr. SHAW. Would you tell us what the balance of the income—what sources the balance came from? And then I want——

Mr. BALL. From the corporate finance department, the public finance department, the institutional sales departments, and the trading desks, those four areas primarily.

Mr. SHAW. What percentage of E.F. Hutton's income came from the shop or the money mobilizer?

Mr. BALL. From what?

Mr. SHAW. The shop or the money mobilizer, on overdrafts.

Mr. BALL. A, I certainly did not know then. I have seen in the SEC study that came out yesterday, that of the—well, that the amount of income to Hutton in 1981 from the wrongful activities—wrongful activities, now—was about $3.5 million of a total net interest profit of $118 million.

The Hutton firm, until after I left, had no segmentation of the interest earned on Bank of America drafts outstanding and the float thereon as opposed to the operation of the drawdown system. And, again, the drawdown system, itself, the active concentrating cash rapidly to reduce Hutton's borrowings to operate its business is not—and I know you are not implying that it is wrongful. So, Hutton at that point did not have segmentation that produced the figure that would show the reduction in expense or profit from the money mobilization department.

Mr. SHAW. Now, Mr. Ball, as a director of the corporation and as president of the corporation, you regularly receive financial statements on the results of operation and the balance sheet of the company; is that not correct?

Mr. BALL. Yes, it is, sir.

Mr. SHAW. Now, on that there is a "checks and drafts payable account." I do not have the balance sheet up here, but as I recall that was the designation given this particular account.

What did you think was in that account? What did you think made up that figure? And if you will see, it runs up to around a half-billion dollars during this period of time.

Mr. BALL. Congressman, when I looked at the balance sheet of Hutton, I was aware that they had checks and drafts outstanding in the normal course of their business, and, therefore, to me checks and drafts outstanding were simply promises to pay by Hutton that had been written as checks or drafts to clients, to other broker dealers, to corporations, in payment for investment banking transactions and the like. I assumed that was what they were.

Mr. SHAW. Did you ever inquire as to what was the makeup of that particular figure? Or, do you recall anybody, in any of your meetings, inquiring as to what the makeup of that figure was?

Mr. BALL. I did not inquire. That I would be virtually certain——

Mr. HUGHES. The gentleman's time has——

Mr. BALL. I do not recall anybody having made inquiry about that, Congressman. And, again, it would seem to be a fairly matter-of-fact statement, there were checks and drafts outstanding and there was a dollar amount of them, and I can't say it is anything that elicited concern on my part, nor do I recall anyone else having asked about the composition of it.

Mr. SHAW. My time has expired.

Mr. HUGHES. The gentleman from Ohio is recognized for 5 minutes.

Mr. FEIGHAN. Thank you, Mr. Chairman.

Mr. Ball, prior to your becoming president of E.F. Hutton in 1977, you had served for 7 years as the retail sales manager; is that correct?

Mr. BALL. Yes, sir; approximately 7 years. I'm not sure of the exact length of time.

Mr. FEIGHAN. Now, as the retail sales manager, I assume that the branch managers reported directly to you.

Mr. BALL. No, they reported either to the regional vice presidents or regional sales managers, who, in turn, reported to me. They did report to people who reported to me, Congressman.

Mr. FEIGHAN. Before they reported to you.

Mr. BALL. Yes, sir.

Mr. FEIGHAN. And those two people had geographical distribution of the branch managers? The two individuals who reported directly to you, who were between yourself and the branch managers had geographical distribution?

Mr. BALL. That's right. You know, there would be a Pacific north region, there would be a Great Lakes region that would encompass Ohio and Michigan and the like.

Mr. FEIGHAN. I assume that during that period of time, this is prior to 1977, the branch managers had some role in cash management as well.

Mr. BALL. When a client buys a stock, they generally will deposit a check with their branch brokerage office. The branch cashier would then physically accomplish the movement of the money to a regional or the national headquarters. The branch managers had oversight over that, although it is not something that they did, themselves. For instance, a branch manager would review new account sheets, they would review the transactions of clients every day; they would not review the movement of money and the makeup of the cashier's work on other than episodic basis.

Mr. **Feighan**. Is it fair for me to assume, then, that as the regional sales manager for E.F. Hutton, for 7 years prior to the presidency, that during that period of time you understood what the cash management practices of E.F. Hutton were?

Mr. **Ball**. No, sir; I knew that Hutton had a cash management system. I was aware that it was designed to move money from a branch to New York as rapidly as possible. I did not know the actual mechanic procedure; and later on I'm told that there was a sheet, a form to be followed, that that was not something which was within my purview, and I did not know what it was. I was aware that it involved——

Can I use an example?

Mr. **Feighan**. Yes.

Mr. **Ball**. If a branch in Boise got a check for $10,000 from a client, and the bank might not make that money available for 3 days, I was aware that Hutton, from its regional or national headquarters, would write a check, let's say today, designed to get to Boise on the same day that the money was made available by the bank, and that that is a method of overdrafting, but only to the extent that there is a client deposit there. I was not aware, while I was with Hutton, of the drawing down of more money than was deposited by clients into the branch.

In other words, to me the deposits represented a glass of water, and you could pour all the water out of the glass, or, if you were inefficient, you only poured part of the water out of the glass; but I had no idea in the world that you could pour more water out of the glass than was there in the first place.

Mr. **Feighan**. After you became president, did you also then, subsequent to that appointment, become a director of the brokerage house?

Mr. **Ball**. I was a director of the broker dealer while I was still national retail sales manager, and continued to be a director, Congressman, thereafter.

Mr. **Feighan**. And did you also serve as a director of the holding company?

Mr. **Ball**. Yes, I did, sir.

Mr. **Feighan**. I'd like to better understand the management style. We've had some reference, now, to the chart that attempts to describe the functioning of management, but that really doesn't convey for us the style of management that was taking place at E.F. Hutton during 1979 to 1982; and my colleague from Florida began to question you about this.

Can you tell us with what regularity you would meet with this grouping of individuals, some of whom have changed, on the second tier of this chart?

Mr. **Ball**. With Mr. Rae, or Mr. Lynch, or Mr. Epstein, or——

Mr. **Feighan**. With that whole group.

Is it fair to assume—I mean, we understand that there was a very loose management structure of sorts. But is it fair to assume that the president of E.F. Hutton was meeting on some at least irregular basis with the individuals who would make up the second tier of this?

Mr. **Ball**. I met—and by "met" I mean I talked with on the phone, I saw on a spontaneous basis, talked with for a few minutes, or had a regular meeting on a particular topic with each of those individuals with quite some frequency.

Again, to be clear about it, those are not people who reported to me. Every company has someone to whom one reports——

Mr. Feighan. I understand—but I was just trying——

Mr. Ball [continuing]. And I was not the one to whom they reported. I interacted with them frequently, Congressman.

Mr. Feighan. And was there any formalized structure or method of meeting with this group of individuals, as with yourself or with the chairman?

I understand it was loose, but it couldn't have been chaotic.

Mr. Ball. Can I answer in two parts?

With the regional vice presidents of Hutton who reported directly to me, I met with each of them once or twice a year on a formal basis; talked to them much more often than that, clearly. And we also had a meeting of the regional vice presidents as a group once or twice a year. With the others who did not report to me, I do not believe there was any regular operating committee, policy committee, or other means of their meeting in official, formal, or regular basis.

Mr. Shaw. Would the gentleman yield to me right at this juncture?

Mr. Feighan. I'd be happy to.

Mr. Shaw. When you get down to talking about the various regional managers, now directly under them are the individual offices; isn't that correct?

And isn't it within these individual offices where the money mobilization took place, where the illegalities occurred?

Mr. Ball. The branches are certainly the places where the moneys came in. And it is also true that in some of the branches, the ones that did the abusive, wrongful, or illegal things, the chaining, I believe it is called, or the other wrongful things——

Mr. Shaw. It is affectionately referred to as "chaining" by this committee, yes, sir.

Mr. Ball [continuing]. Were done. The control, the oversight, the checks and balances and the methodology and the standard practices for the money management area did not exist within that retail sales structure, however, it was the money mobilization department that developed the policies, reviewed what was being done. And then there were others, supposedly, to look at their practices.

Mr. Shaw. Well, what you are saying to us, Mr. Ball, if I'm correctly following you, is that the scheme, well, it was masterminded elsewhere but it took place in the regional office, which is under the regional sales manager, which was your position at one time and which does report to the president.

Mr. Ball. The wrongdoings took place, I think, not in the regional offices but in the branch offices, for money mobilization purposes.

Mr. Shaw. The branch offices, which are under the regional offices; that is correct.

Mr. Ball. For those purposes the branch managers and their operational employees reported to the regional operations managers who, in turn, had a man, a Mr. Genin, who was in part of the operations department, who was the head of retail sales liaison.

Again, that's on just—I'm not trying to introduce——

Mr. HUGHES. Would the gentleman yield to me?

Mr. FEIGHAN. Be glad to yield.

Mr. HUGHES. We won't take it out of his time.

You know what you would have us believe, Mr. Ball, in essence? You would have us to believe that on this organizational chart, even though you are president of the company and you are in charge of all the sales regions in the country which had to carry out this scheme, that you didn't know that this aggressive overdrafting was done because you had no responsibility over any of the other departments, including the department where the money mobilizer was, and at no time did that come to your attention. And yet you are in charge.

You are in charge. President of the company, you are in charge of all the domestic sales regions which had to carry it out, and you're in charge of maximizing interest profits and other profits of the company; and even though you are president of the company, you are on the board of directors, you would have us believe that you didn't know what was going on.

Mr. BALL. I did not know what was going on of an abusive nature.

Mr. HUGHES. That is interesting, because nobody else knows what was going on. The branches all say they didn't know what was going on, and when they did—they knew what was going on, but it came from higher authority. Headquarters say they didn't know what was going on. The regional vice presidents say they didn't know what was going on. It is interesting how nobody knew what was going on.

Mr. SHAW. Mr. Chairman, I just noted here on the chart that operations under Epstein—I don't think our chart—our chart needs some more lines, because it appears that the operations under Mr. Epstein should have a line back over to the branch managers, I guess.

Mr. BALL. The regional managers, the regional operations managers reported to the operations part of the firm, i.e., to the money mobilizer as to cash management, not to me. If it helps to say that one more time, when it comes to the money management system, the regional operations managers reported to the money mobilizer as opposed to the regional vice presidents, and, therefore, not directly or indirectly to me.

And, again, I think the testimony that you have had from Mr. Morley, for example, as I saw on one of the tapes, would tend to confirm that.

Mr. HUGHES. Well, Mr. Morley—if the gentleman would yield—told us he didn't know anything about it. Mr. Morley testified before this committee that he wasn't aware that this aggressive overdrafting was being done.

Mr. BALL. Mr. Chairman, one of the awkward things for me, having come here after a number of people from Hutton had said, quote, "I don't know about it, I am sort of——

Mr. HUGHES. I know, you're the last of the ones that——

Mr. BALL. I'm the last of several, and unfortunately——

Mr. **HUGHES**. You're last but not least, I can assure you.

The gentleman still has some time, from Ohio.

Mr. **FEIGHAN**. Mr. Ball, where on this chart would Mr. Morley appear?

Mr. **BALL**. Mr. Morley, on this chart, would appear as reporting to the cashiering sector, which is run by Bob Ross, Congressman.

Mr. **FEIGHAN**. Which ultimately, then, reports to Mr. Epstein.

Mr. **BALL**. Yes, sir.

Mr. **FEIGHAN**. Between yourself and your branch managers, for reporting purposes, then, there were only, then, the regional managers; is that correct?

Mr. **BALL**. There were branch managers, regional sales managers, regional vice presidents and me in the regions, themselves, the geographic regions. There was, I think in every case—in every case—a regional operations manager who was in charge of the margin accounts of the region and who was also in charge of the other nonsales functions, such as cash management. When it came to the cash management area, they reported to Mr. Morley as opposed to anybody else.

Mr. **FEIGHAN**. I understand.

How often would you have an opportunity, during your presidency, to meet with branch managers, whether or not any of those regional managers would be present?

Mr. **BALL**. I spoke with groups of branch managers who would come to Hutton for training programs. I would speak at regional branch manager meetings with frequency. If a branch manager was in town, or if a salesman or a saleswoman was in town, they would sometimes stop by and say "hello" to me.

Mr. **FEIGHAN**. So, there was no formalized schedule of meetings.

Mr. **BALL**. As president, there was no regular schedule for me to meet with a branch manager. There were 300 and some odd——

Mr. **FEIGHAN**. I understand.

Was Mr. Morley at any of those meetings, to your recollection?

Mr. **BALL**. I believe Mr. Morley spoke to a number of the regional—of the meetings held by the different regions at which their branch managers were attendees.

Mr. **FEIGHAN**. And at which you were present?

Mr. **BALL**. At which I was present, although not contemporaneously with him. In other words, I would go in and speak, and then go off and do something else.

Mr. **FEIGHAN**. I have just one final question, Mr. Ball.

At any time during your presidency at E.F. Hutton, do you have any recollection of any branch manager or any of the regional managers whom you just described ever expressing concern to you about the cash management practices that they had to participate in or that they were participating in?

Mr. **BALL**. No, I do not remember that, Congressman.

Mr. **FEIGHAN**. Thank you.

Mr. **HUGHES**. The gentleman from Florida is recognized for 5 minutes.

Thank you, Mr. Chairman.

Mr. **MCCOLLUM**. Mr. Ball, isn't the bottom line of all of this with E.F. Hutton, that there simply was an inadequate, or, at the very least, a failure of the internal control systems dealing with cash management, so that the aggressive overdrafting was not caught? Isn't that the very least we can say about the problems there?

Mr. **Ball.** Yes.

Mr. **McCollum.** In the process of all of this, somebody had to be responsible, or "somebodies," in the company, for making sure that that internal control system was there. It seems to me that we can conclude without any further evidence, from the circumstances that have been presented to us in Attorney General Bell's report and all of the evidence before us, that there was a screwup on the part of Mr. Morley and on, probably, the part of Mr. Lynch, in not catching this or having, at least, the responsibility to catch the internal control system.

Is that not true?

Mr. **Ball.** It certainly should have been caught. It should have been caught at the money management level, in my estimation, and as to other——

Mr. **McCollum.** And Mr. Morley and Mr. Lynch were in charge of the money management levels, were they not—Mr. Epstein, Mr. Morley and Mr. Lynch, all three of them in one level or another?

Mr. **Ball.** That is what is reported in, for example, Judge Bell's study, and that certainly is——

Mr. **McCollum.** Well, and that was your understanding of how it functioned when you worked there?

Mr. **Ball.** That is similar to my understanding of how Hutton functioned at that time, yes.

Mr. **McCollum.** Wasn't that your understanding at that time of how it functioned?

Mr. **Ball.** Yes. I was just trying to simplify my understanding by saying it was the same as that which you have read.

Mr. **McCollum.** OK. It seems to me, though, at the same time, while you may not have technically been in the chain of all of this processing that you've described to us today, that a lot of people out in the field seemed to think that you were; that is, you sent memos out trying to maximize profits.

Now, in retrospect, don't you think that those were perhaps misleading to the extent that they gave the impression you had a role to play that maybe you didn't?

Mr. **Ball.** One of my important jobs at Hutton, and one for which I do not apologize, was to try to motivate people to do things better. And by better I'm not just saying make more profits, but I'm saying to maximize their abilities to maximize the achievements in their offices.

In a business as complex as an E.F. Hutton and the securities business in 1980, there is no way that any one person could be expert or knowledgeable of the details of every facet. One of the things that I did with frequency was to send memos to direct people at Hutton to——

Natesh Mohan, who was the head of the communications department—now, I promise you I don't know very much about the cost of a centrex system against the cost of a plug switchboard, but I sent them to Nap and I think they probably did a good job of advising him of what to do. I referred people to, for example, the head of the Government bond department, and although I know what a Government bond is, in terms of the complexity of trading I had to rely on that person for being skilled and doing it properly.

In a period of just escalating interest rates, when interest profit became important, it was my understanding and belief that Tom Morley and the money mobilization department could help Hutton to do that more effectively, and, thereby, to maximize their interest profit, minimize their interest expense, issued simultaneously.

Mr. McCOLLUM. So, you issued memos and did encouraging things to try to get them to do what you thought was the better job or to improve whatever they were doing, and it was just a rah-rah type of thing is what you are saying to us.

Mr. BALL. It was both rah-rah and directional.

Mr. McCOLLUM. But the key to this thing—and you are confirming what I am trying to say, not to try to put any words in your mouth, but you were the president of the company, you had a figurehead position. Granted, there is a chairman and a chief operating officer, but the president has a role to play, even if he isn't at every detail, to be the figurehead and to be the focal point for a lot of these things. And it seems to me that you did do that, in part, in what you were attempting to do.

And what bothers me about this—and let's assume all that you say is true and give you the benefit of every doubt in this entire case as far as your responsibilities, the chain of command, everything else. But even assuming all of that is so, in the eyes of the stockholders and in the eyes of the public, and in the eyes, apparently, of a good many people in the field, whether they knew the chain or should have known it better than they did, you were a major player who should have a role, if not—even if you didn't—in the responsibilities for seeing to it that there was a proper internal control system on money management, and that the system didn't break down as it did. That is the part that bothers me.

You can say that you didn't, and I know you're saying that you didn't have that role. And I'm just saying to you that let's assume you did not and give you every benefit of the doubt, there's still a problem with the public. Presidents of corporations as big as E.F. Hutton, it seems to me, normally are held accountable—"the buck stops here"—in terms of the responsibility that is here, and I don't know how you can escape that with us.

Mr. BALL. The responsibility for the cash management control system and the checks and balances, to see that it did not go out of kilter, was not within my operating bailiwick, period. However, like every other director of a public company, like every other senior corporate officer, with or without the title of president—and I was not the chief operating or chief administrative officer, and no one is contending that I was—we all want things to be done better, and certainly to everyone in a company embarrassed by a breakdown in a control system such as existed at Hutton, we darn well wish that there had been some glimmer, some knowledge, some bit of edification that would have brought it to light earlier.

I did, Mr. Congressman, on several occasions, write memos to people asking about branches that had high interest profits, unusually high profits, inquiring as to why; even though interest profitability, for example, was not my particular realm of responsibility.

At no time did I get a response that would lead anyone to believe that there were improper actions to be done.

Mr. McCollum. Well, let me say this—and I don't want to dwell on this, but even if you had no greater responsibilities in this area than any other director——

You were a director, you say, as well?

Mr. Ball. Yes, sir.

Mr. McCollum [continuing]. It seems to me that you, as a director, are much like a baseball team manager: when they start losing, the team starts losing, the public and the management above you and around you and everywhere else are going to hold you responsible for that. I guess that's sort of the American way in this case.

That's all. I yield back.

Mr. Hughes. The gentleman from Florida is recognized for 5 minutes.

Mr. Smith. Thank you, Mr. Chairman.

Mr. Ball, the testimony heretofore, for the last few months, has been very cloudy on the issue of anybody being able to be pinpointed or targeted directly for responsibility for actually deciding and instituting the cash management program on the basis of drawdowns becoming excessive and then further excessive, and to the point where, as you know—I think your theory is the glass of water—you can't pour out more water from a glass than is in the glass; which Hutton managed to do at some point in time. We've heard testimony from people—Mr. Lynch, others—who said that they had put in motion the normal, New Cash Management Program, which then, due to zealousness, according to Mr. Fomon, due to the competitive nature, region by region, branch office by branch office, became excessive but was never authorized or in any way initiated by management.

I'm going to ask you whether or not you think, during the tenure that you had as the president of the E.F. Hutton Group, which was the domestic sales group, and in which, through Mr. Morrison's questions we at least know that to some degree cash management and interest income was an important part if not the most important part of your process, if you think that a situation that developed at Hutton, which eventually became the scheme known as kiting or excessive check kiting or cash management excesses and drawing down significantly more than had ever been placed in the account, if you think that could have happened in every region in almost the same exact way, if checkbooks were printed and accounts opened at the highest levels of management and then delivered to branch managers by upper or senior level management without some coordination by the upper management level of E.F. Hutton & Co. in the domestic sales area, could that have just occurred without anybody getting involved in it, branch managers getting checkbooks delivered to them from accounts that had been opened by people they didn't know and getting phone calls every single day as to how much money to draw down, and how much and where to place it, in other words, what banks to draw it to, where to draw the checks to, et cetera? Could that have happened spontaneously and exactly the same in almost every region of the country?

Mr. BALL. Congressman, I think you've asked about four questions. Let me try to take them in segments, and if my order is not what you would like please let me know and I'll try to do it in a different sequence.

First, yes, people at Hutton and branch managers, regional vice presidents, were encouraged to increase profitability. That is a proper, and I would say an honorable, corporate function. I certainly don't apologize for that, nor are you indicating, I think——

Mr. SMITH. Absolutely not. Absolutely not.

Mr. BALL [continuing]. That there is anything whatsoever wrong with that.

Second, as you know, I have not been at Hutton since mid-1982, and, therefore, what has transpired in investigations since that point in time I don't know; so I can really only speak of the period prior to mid-1982.

Mr. SMITH. That is the framework within which I asked the question, from the time of your tenure as president.

Mr. BALL. Yes, you did.

Third, in terms of things like checkbooks given to branches drawn on New York banks, which I think were called branch——

Mr. SMITH. Checkbooks were delivered from banks in other cities?

Mr. BALL. Yes. That is something that I didn't even know occurred until a year or two after I left Hutton, when I just heard about events within this thing. I just didn't know that it took place.

Did it take place similarly in every region?

Having read some of the reports, I don't think it was identical, but it clearly happened in more than one place, so I'm not trying to gainsay your point.

How did it happen? Was it word of mouth from a regional operations manager to another regional operations manager from the money mobilization department to someone else?

I don't know. Again, since I haven't been at Hutton, I'm not sure. I wish I could give you an explanation, or name, or something, but it's territory where I just plain don't know the answer, sir, and I'm sorry.

Mr. SMITH. Let me ask you the question: Since you were responsible for the profitability of your division, the E.F. Hutton Group, the domestic retail sales, part of any overall profitability would have been interest income?

Mr. BALL. Yes, sir.

Mr. SMITH. During your tenure, from the time in 1981 until you left in 1982—and the New Management Program had been instituted at that time, cash mobilization, cash management, et cetera—did you begin to get reports of increasing amounts of profit, interest income profit? Was there a time when the amount reached proportions which were beyond the normal expectations for money management?

And, as a secondary part of that question, did you ever review the month-to-month accounting statement submitted by Arthur Andersen? Did you ever have anything to do with looking over those statements?

Mr. BALL. Again, I guess there were three questions——

Mr. SMITH. Just two.

Mr. **Ball**. Just two?

Can I answer three, Congressman?

No, I'm kidding. Excuse me.

Mr. **Smith**. If you would provide me with an answer, you can answer them if you say there are 20.

Mr. **Ball**. The interest income of Hutton in 1980, 1981, 1982, was increasing and at a relatively rapid rate. The great majority of that was actually a function of interest rates in the U.S. economy going up to just unprecedented levels and creating relationships that were very different than——

Mr. **Smith**. Can we stop there?

That's not so. You know, I heard that before from a number of witnesses, and I want to put an end to this bogus issue. President Reagan ran on a policy of driving down what were then 20 and 21 percent interest rates under Carter in the late 1980's, and in 1981 and 1982, interest rates took a significant nose dive from those rates, from 22 to 9 or 10 or whatever, and then they crawled back up.

I don't understand that line of logic, that interest rates were increasing significantly. If interest income was being made on 10, 11, and 12 percent, why wasn't it being made even more so when the interest rate was 22 percent?

Mr. **Ball**. I think, actually, interest rates went up through late 1981 and then began to come down in late 1981 and into 1982; although I don't carry a perfect map around, but I think that was the actual sequence.

Mr. **Smith**. Yes, but the year before that the rates had been up at 22 percent for about a 3 to 6 month period.

Mr. **Ball**. Yes.

Mr. **Smith**. And I keep hearing that there was this enormous rise in interest rate profitability at Hutton because interest rates were on the rise, when a year before that—a year and a half before that—interest rates had been almost double what they were at that period of time, and I don't understand why this was so significant.

Mr. **Ball**. Not to quibble, I think it was in 1982 when they came down.

But in any event, Hutton itself, as a company, was undergoing a period of very rapid growth. I believe, based on things——

Mr. **Smith**. Let me stop you there. You just indicated, in your previous testimony in response to a question, that you were in a period of no hire, and that you, at one point, authorized—which you said you didn't normally do—a messenger's hire. Now you're telling me that Hutton was in a period of rapid growth and, at the same time, they were in a period of no hire? That's a little bit——

Mr. **Ball**. No, this memo was in 1982, and I think at that point in time the brokerage business was starting to get squeezed pretty badly in profits, because its cost structure is blown up in 1980–81, then, as interest rates do, as you say, come down, things are hurting.

Third, Hutton, as a means of combating this squeeze on profit margins and the like, opens a number of new branches during this period, and is, therefore, on the revenue front, doing a number of things to try to mitigate the other influences that would otherwise have impacted its profits and profit margin.

Congressman, now having said I would answer three questions, I answered one and I've forgotten the second. Could you back to that one?

Mr. SMITH. Well, the one about the fact that there were enormous amounts of new accounts being opened by other parts of the corporation other than the branch managers, information flowing from above about which accounts to draw checks on, to what accounts to forward those checks to, et cetera, and how much money to move.

And this was almost the same from region to region. Oh, yes, the banks were different, the chaining was different; but in the end, the methodology, from region to region, was exactly the same.

Now, could that happen without anybody being advised of it at senior management level, given what you know about your group.

I'm not saying you had responsibility for that. Given that you represented 70 percent of the total sales of that company, you apparently had to know the design, the way the company ran, even outside of your own group.

Mr. BALL. Congressman, clearly a corporation is not a disembodied entity unto itself. It think that is one of the things that's been bothering the subcommittee, is people are saying, "Well, Hutton is composed of people; only people can do things."

Obviously, somebody within Hutton knew about sending checkbooks to branches and drawdown systems that went beyond a normal "you put a dollar in, you take a dollar out." One would be foolish to say that was not the case.

Did that exist at the senior most levels of Hutton?

I did not know it, and as to others, I can only refer you to other testimony that you have heard.

Who knew it?

At a functional level, I don't know, Congressman.

Mr. SMITH. Well, let me ask you the one last question, and I appreciate your frankness.

Interest income was an important part of what you had to do in terms of profitability of your division. In 1981 and 1982, there began to become a scheme evolving out of what might have been a legitimate, legal way to utilize money, cash management. Arthur Andersen did weekly and monthly analyses. There was an external, independent audit committee that dealt with all of the issues, that saw the statements every month. There were internal controls, even in your division, on the movement of money, on danger signs. I mean, there was a whole accounting procedure.

There came a point, even by the testimony we elicited, that there was an enormous disparity every month between the bottom line of cash on hand and the bottom line of instruments due and payable, because you know, at the end of the month they couldn't always clear out and make even the amount of money they had moved as opposed to the amount of money that had come in.

Did you ever see any of those?

Do you know any of the independent audit people, whether they were ever advised?

What happened to the red flags? I mean, what happened to the internal controls?

Now that you are outside of it, now that you see it from a different perspective, can you give me any idea if you would have thought that Hutton's administrative scheme that was set in place at some point in time—not the scheme of kiting but the original way to run the company—could have broken down this significantly, to allow this kind of thing to happen without anybody picking it up?

Mr. BALL. I am very surprised, Congressman, that the controls checks and balances that were extant within Hutton did not pick it up.

Again, I was president of the company, I was not the chief operating or administrative officer. I was not on the audit committee, I did not meet with the people from Arthur Andersen. As I said in my statement, even after the problem came up I was not involved in the meetings and the discussions relating to the cure therefor.

I am surprised that the structure of Hutton, the organization of Hutton, did not at a fairly early point pick up the abusive or excessive activities.

Again, did they have a drawdown system? Sure.

Did it involve anticipation of moneys being made available?

I know that, and I don't think the subcommittee is attacking that as being, in any way, improper.

As to the things that cannot and should not be defended, I am surprised they were not noted earlier.

Mr. SMITH. Mr. Chairman, I know my time has expired. I would just like to ask Mr. Ball if he could answer a short question or maybe submit it for the record.

Mr. HUGHES. Please.

Mr. SMITH. Since profitability was such an important part of it, and you say that you weren't on the audit committee and that you didn't receive the audits, how did you get knowledge of how much interest income was being earned, if that was part of your responsibility? Did somebody else report to you about it, the one that read those monthly submissions by Arthur Andersen?

Mr. BALL. There were—and I think the subcommittee has seen a number of summary form internal P&L's, but it would simply show either interest profit as a single line item or interest income and then interest expense with interest profit as a derivative. And those weren't Arthur Andersen things, those were internal; and those were the profit and loss statements that I——

Mr. SMITH. Did any of those ever set off a red flag in your head about the size of the interest income?

Mr. BALL. There were, and I think the subcommittee has seen four or five—several—memos that I wrote on different occasions asking about the size of interest income. And, again, at no time did I receive a response that indicated any impropriety.

Mr. SMITH. Thank you.

Thank you, Mr. Chairman.

Mr. HUGHES. I'd like to pick up on that, if I might.

It is a fact, is it not, Mr. Ball, that you were aware of the overdrafting that was taking place?

Mr. BALL. Congressman, I——

Mr. HUGHES. You were aware of the overdrafting which was taking place?

Mr. BALL. I was aware that Hutton's drawdown system——

Mr. HUGHES. Oh, no. Answer my question.

You know what overdraft means, don't you?

Mr. BALL. To the extent——

Mr. HUGHES. Do you know what overdraft means?

Mr. BALL. I was going to give you a definition which I understand in order——

Mr. HUGHES. Well, all you have to give me is a yes or no.

Mr. BALL. I understand overdrafting as a commercial practice, sir, yes.

Mr. HUGHES. Overdrafting means pouring more water out of a glass than you have in the glass, isn't it?

Mr. BALL. No, sir?

Mr. HUGHES. It's not?

Overdrafting is not taking more out of a bank than you have in the bank?

Mr. BALL. No, sir; nor was the Hutton drawdown system, for example, when I was a branch manager, one which involved taking more money out of a bank than you would put into it.

Mr. HUGHES. What did you understand was meant when you received memos indicating the amount of interest profit that was being accumulated because of overdrafting?

Memo to you from Tom Lillis, indicating why there was a difference in certain branches over other branches, Casper and Washington, DC, branches: "they overdraft substantially through Bill Sullivan." What did you think that meant?

Mr. BALL. I had asked, having seen the memo prior to this hearing, Congressman, a question as to the level of interest profit in two offices, Casper and Washington.

Incidentally, by the way, this Washington office——

Mr. HUGHES. But you aren't answering my question.

My question is: What did you think that meant?

Do you understand that question?

Mr. BALL. I thought that it meant anticipating the availability of funds which had been deposited in a branch—in a bank, excuse me, Mr. Chairman.

Mr. HUGHES. What is meant by "overdraft substantially through Bill Sullivan"?

Mr. BALL. Well, to me——

Mr. HUGHES. I want to caution counsel. Counsel is present to give legal advice, not to help the witness answer questions. And this is not the first time counsel has assisted. The witness can answer the questions.

Mr. BALL. To me, Congressman, overdrafting, in this context—and it says "overdrafting substantially through Bill Sullivan in New York"—meant that the branch office was receiving substantial deposits, that Bill Sullivan in New York was anticipating the availability of those funds being made available in the branch's bank, and, therefore, that—with interest rates at 20 percent, as I said in this particular memo—it is a very profitable item for the branches.

Mr. HUGHES. What is meant by "substantially overdrafting"?

Mr. BALL. I think it says "overdraft substantially." And to me that would mean——

Mr. HUGHES. There is a difference between the two?

What is meant by "overdraft substantially"?

Mr. BALL. To me it means that they are drawing down effectively large deposits—deposits that, in the cumulative, are large within a branch office.

Mr. HUGHES. Did it occur to you that that meant that they were drawing down much more than they had in the account?

Mr. BALL. No, it did not. The memo was written to me by a senior accounting officer of E.F. Hutton. I don't think that there is any connotation within the memo that they were doing things wrong.

Mr. HUGHES. Who?

Mr. BALL. And Congressman, incidentally, I think that these are not offices that were found to have engaged in the excesses, the Washington office——

Mr. HUGHES. I didn't ask you that question.

Mr. BALL. I'm sorry. Excuse me.

Mr. HUGHES. Who is Tom Lillis?

Mr. BALL. Tom Lillis is a vice president or a first vice president in the E.F. Hutton Accounting Department.

Mr. HUGHES. In the accounting department.

Mr. BALL. Yes, sir.

Mr. HUGHES. Did you have direct line responsibility over Tom Lillis?

Mr. BALL. No, I did not.

[The information follows:]

EXHIBIT IV

[Memorandum from E.F. Hutton, Apr. 23, 1980]

To: George Ball.
From: Tom Lillis.
Subject: Interest Income.

Mike Castellano requested that I answer your question regarding the interest income of the Casper and Washington D.C. branches.

The Casper office earned in excess of $30,000 of net interest income for the month of March, 1980. In fact, the average net interest income for the last five months has been $31,400. The Washington, D.C. office earned $82,500 of net interest income in March, 1980. Both offices have one thing in common; they overdraft substantially through Bill Sullivan in New York. At 20% interest, it is a very profitable product for the branches.

Below is a breakdown of net interest income for both offices.

	Casper	Washington
Net margin interest	$500	$8,000
Net interest on free credits, short sales, et cetera	[1] 5,500	27,000
Net general ledger interest (almost entirely due to BOA drafts outstanding and overdrafting)	[1] 24,400	47,500
Total	30,400	82,500

[1] Further detail is not available without delivery of requested programming or substantial additional manual effort.

If you have any further questions, please let me know.

Mr. HUGHES. But you had a memo from Tom Lillis, bringing to your attention the difference between Casper and Washington, DC, was that they were substantially overdrafting.

Mr. BALL. Sir, I'm not sure that—it says that, "the difference between them." It does not say that they were both overdrafting substantially.

Mr. HUGHES. That explained why they had so much interest profit.

So you were aware of the fact, from this memo back on April 23, 1980, that branches were substantially overdrafting.

Mr. BALL. I was aware that the branches were overdrafting. Mr. Lillis used the word "substantially." I'm not sure that I focused on it at the time, nor would I.

To me, what was of more interest was the—and excuse me for using "interest" in that context—was the phrase, "at 20 percent interest," or "interest rates."

Mr. HUGHES. Now, Mr. Ball. Come on, now, Mr. Ball. You were the president of the company. It was your job to maximize interest profits. And you are suggesting to us that the word "substantially overdrafting" or "overdrafting substantially" really didn't mean anything at that time?

Mr. BALL. It did not raise any red flag, Congressman, at that time.

Mr. HUGHES. Well, you received a number of memos, did you not, indicating why there were differences between the regions—some regions were overdrafting substantially, other regions were not?

You did receive memos along that line, did you not?

Mr. BALL. Congressman, in my files covering this period, there were 25,000 memos that I wrote or received, and there may be some that say there were branches or regions that were overdrafting or overdrafting substantially. And, again, at times I ask questions such as this as to the rationale behind it or the reason for the interest profitability or other forms of profit at Hutton.

Mr. HUGHES. Well, you did know the significance of overdrafting, did you not?

You know what overdrafting can do for a company, and you know what substantially overdrafting will do for a company, don't you?

Mr. BALL. Congressman, no. At that time my understanding of overdrafting——

Mr. HUGHES. You are on the board of directors, you are president of the company, and you don't know what impact overdrafting and substantially overdrafting does for a company's profit margin.

Is that what you're trying to tell this committee?

Mr. BALL. I was well aware that by moving money from a branch to New York rapidly, the firm could minimize its interest expense——

Mr. HUGHES. Now you're not answering my question.

Mr. BALL [continuing]. And thereby—I think I am, Congressman.

Mr. HUGHES. You're not answering my question.

My question—I'll repeat it—my question was: What you're trying to tell us, you were president of the company, you were in charge of all the regional and branch offices, basically, you were on the board of directors, and you didn't know what impact on the profit margin overdrafting or substantially overdrafting would have?

Mr. BALL. That, in the context you are asking it, Mr. Chairman, is correct.

Mr. HUGHES. I'm going to ask you to examine a memorandum, which I am going to ask counsel to provide for you, dated March 25, 1980, which basically is a memo from Norman Epstein to yourself, then a memorandum from yourself, George Ball, to Bob Witt and Carrington Clark, dated March 19, 1980, and March 25, 1980, respectively, which I offer for the record. Without objection.

[The documents referred to follow:]

MARCH 25, 1980.

To: Bob Witt and Carrington Clark.
From: George Ball.
Subject: Canadian Affiliate.

I'm reluctantly in agreement with Norm that we shouldn't undertake the Huttonization of Greenshields at this time. The differences in margins and certain of the clearance functions would be particularly difficult; the amount of programming and other preparation would simply drain us of already thin resources.

It is unfortunate that we can't proceed at this time, for the opportunity is a relatively low risk, high profit and perhaps unique opportunity to establish a Hutton profit-presence in a large and growing market. Factually, however, we just don't have the people-power to do it now.

On a separate point, there seems to be some murkiness as to whether or not we could easily support an office in Calgary (at first manually, and then gradually developing systems which could perhaps lead to the capability to accomodate the assumption of a Greenshields-like operation). By copy of this memo, I'm asking Norm to clarify this point.

GEORGE L. BALL.

MARCH 19, 1980.

To: George Ball.
From: Norman Epstein.

George, after having reviewed Bob Ross' Canadian Markets Study and his writeup on Greenshields Books and Records I am recommending that we put on a back burner, the facilities management idea we had as a basis for profit sharing with Greenshields.

To successfully convert and integrate the Greenshields Operation with our own, would require significant amounts of executive time which currently we could ill afford to lose. By the way, for starters, the executives I'm referring to are Bob Ross, Susan Lem, Richard Genin, Bernie Weinstein, Ron Cook, Mike Castellano and Paul Underwood.

In addition to the significant executive effort, a major programming effort would have to be undertaken. We would have to accommodate multiple currencies, a new AE commission system and a new margin system, all large scale projects. In addition there would be other programming requirements in the intermediate class but what it adds up to is a very major effort.

One apparently obvious alternative would be for us to purchase and modify the existing IBM Canada Brokerage package, but that package is not for sale. Another alternative would be to have the programming done outside, but this would still take a great deal of management time in order to define and control the project.

Bob Ross points out the Canadian exchanges have a "vested" interest in having firms participate in the IBM Canada System and the exchanges prefer to receive input from one source rather than a multiplicity of brokers. Whether true or not is not as important as the fact that no U.S. Brokers in Canada are doing what we are, in effect, doing for our London Commodity Operation. That is, processing here for there. For that matter no U.S. Broker is processing in Canada for Canada other than on the IBM Service Bureau. I'm not suggesting that because it is not being done we should not attempt doing it. I am suggesting it is much larger than a breadbox, it is more akin to an elephant.

In addition to the operations area there are two other factors we should consider in light of their contribution to our own P&L.

1. The system of over-drafting is not available in the Canadian Markets necessitating much higher outside sources of capital, or increased debt.

2. The Canadian Market currently enjoys fixed commission rates. It is expected within the next year competitive commissions will begin.

If we were living in the world of October, November and December 1979 I would be a strong proponent of Operation Canada, but we are living, happily, in the world of January, February and March 1980 and any dilution of our current resources or redirection of our priorities scares me.

NORM EPSTEIN.

Mr. BALL. Yes, sir, I have seen it. I have read it.

Mr. HUGHES. Are you familiar with that memorandum?

Mr. BALL. Yes, I am, Mr. Chairman. I have now read the memorandum.

Mr. HUGHES. First of all, the memorandum comes from Norman Epstein to George Ball. Norman Epstein, from your testimony, was in charge of money mobilization in the company.

Mr. BALL. I said he was head of the operations department, primarily.

Mr. HUGHES. Operations department, which had money mobilization, did it not? That's one of the functions.

Mr. BALL. Yes, sir.

Mr. HUGHES. And it is from him to yourself as president of the company.

Can you tell me who Bob Witt and Carrington Clark are—who they were back in 1980?

Mr. BALL. Bob Witt was the regional vice president in charge of E.F. Hutton's New England region, Carrington Clark was an individual who worked in Canada with oversight over an investment that Hutton had into a company called Greenshields, which was a Canadian broker dealer.

Mr. HUGHES. Now basically, the memorandum in essence says—and I'm going to summarize it, and you tell me if you agree with it—that at this point a decision was made by yourself and others not to Huttonize Greenshields at this time, for a number of reasons.

Isn't that so? Wasn't that the decision?

Mr. BALL. Yes. The reasons being that the computer work required to bring it into the operational system would be inordinately large.

Mr. HUGHES. Now, one of the reasons was that—and I'm going to read right from the report:

"The system of overdrafting is not available in the Canadian markets. necessitating much higher outside sources of capital or increased debt."

Mr. BALL. Yes, sir.

Mr. HUGHES. Now what does that mean, Mr. Ball?

Mr. BALL. Congressman, I believe that it means——

Let me start by saying, I don't know specifically what it means. I would interpret it to say that the Canadian banking system does not permit the movement of funds from an outlying branch to a headquarters as rapidly as possible, thereby requiring more capital or capital funds to exist at the parent broker-dealer level.

Mr. HUGHES. Mr. Ball, you were on the board of directors, you were president of the company, and you're telling us that you are not sure what it means?

I'll tell you what I think it means, and you tell me if you disagree. I think it means that one of the reasons why you didn't enter the Canadian market at this time was because in Canada you couldn't practice the overdrafting, or the substantial overdrafting, and as a result you would have to go to the bank and borrow the money instead of using the bank's money.

Is that what it means?

Mr. BALL. Congressman, can I read just two sentences from my memo that is sent to the people in charge?

Mr. HUGHES. Just answer my question, then you can read some sentences.

Do you disagree with that interpretation?

Mr. BALL. I disagree with that interpretation as being the cause of my answer.

Mr. HUGHES. No, I didn't ask you that. I asked you if this was brought to your attention as one of the reasons why it was recommended that you not Huttonize the Greenshields in Canada, and one of the reasons advanced by Norm Epstein—and he is bringing it to your attention—is that the system of overdrafting is not available in the Canadian market, necessitating much higher outside sources of capital or increased debt.

Isn't that what it says?

Mr. BALL. That is what it says, yes.

Mr. HUGHES. How can it be read any other way?

Do you have another interpretation of that?

Mr. BALL. I was simply interpreting the memorandum's main thrust differently, Mr. Chairman, for what I say here, it is unfortunate we can't proceed to Huttonize Greenshield at this time, for the opportunity is a "low risk, high profit, and perhaps unique opportunity to establish a Hutton profit-presence in a large and growing market," meaning Canada. "Factually, however, we just don't have the people-power to do it now."

I certainly agree that Mr. Epstein said that the ability to overdraft is not available in the Canadian market. I'm not trying to——

Mr. HUGHES. Well, you understood what he meant by that, didn't you?

Did you understand what he meant by that?

You told us before that you weren't sure. Is that the answer you want to stick by?

Mr. BALL. He clearly said that one cannot overdraft in the Canadian market. But I would like to draw——

Mr. HUGHES. My question is, is your answer that you didn't understand what that meant?

Mr. BALL. I did not understand the specific operation of the Canadian banking market. But certainly there is a connotation in it saying one cannot——

Mr. HUGHES. That is not the question, Mr. Ball.

The question I asked you is, do you understand the significance of that statement?

Mr. Epstein is saying, "For a myriad of reasons, I don't advise we do it." And you say for other reasons you agree. But in the context of it, you have a memo which you read, and in it he says to you, "In addition to the other reasons, overdrafting is not available, which means that we're going to have higher costs because those sources of capital are not going to be available."

Mr. BALL. That clearly is a fact——

Mr. HUGHES. Do you understand what that means, is my question.

Mr. BALL. I certainly understand the statement. I do not understand the operation of the Canadian banking market——

Mr. SMITH. Would the gentleman yield?

Mr. HUGHES. Be happy to yield to the gentleman.

Mr. SMITH. In the first page of that memo, which is the memo from you to Witt and Carrington Clark, you indicate: "The differences in margins and certain of the clearance functions would be particularly difficult."

Can you explain what you meant by "clearance functions"?

Mr. BALL. Yes. The difference in margins means how you keep——

Mr. SMITH. No, no. I understand.

The difference in clearance functions?

Mr. BALL. The clearance function is the settlement of a securities transaction, Congressman.

Mr. SMITH. And not the clearance of money in the bank?

Mr. BALL. No. It is the clearance of a securities transaction.

Mr. SMITH. Thank you.

Mr. HUGHES. Well, the money mobilization practice you did know was a practice in place at Hutton, there was money mobilization practice.

Mr. BALL. Yes, sir.

Mr. HUGHES. Was it your understanding that it was a mechanical type of practice, and that is that the various branches in the regions were directed to mobilize in a particular way?

Mr. BALL. Yes.

Mr. HUGHES. You were aware of the fact that there was a drawdown sheet that was used by your various people at the branch offices?

Mr. BALL. I do not believe that I had seen that sheet while I was at Hutton, and I am not certain that I was aware there was a sheet. I knew that there was a set procedure, whether formalized——

Mr. HUGHES. But you understood it was a mechanical procedure, didn't you, that there were certain rules that were to be followed by the various branches?

Mr. BALL. There were certain policies to be followed by the branches, yes.

Mr. HUGHES. That are cash management. You knew that the effort was to bring the money to a special account as rapidly as you can to maximize your interest profits. You understood that.

Mr. BALL. Yes, sir.

Mr. HUGHES. And that was part of your job, to try to maximize that interest profit, wasn't it?

Mr. BALL. I wanted the branches to maximize all elements of their revenue stream, income profits, and to minimize their costs, so, yes.

Mr. HUGHES. And part of that was a directive that had to go out from someone, would you agree, at headquarters, as to what the practice would be?

Mr. BALL. Yes; certainly, if one has a cash management policy, there has to be a developer of that policy.

Mr. **Hughes**. Now, there came a time when you became aware of the chaining that was taking place.

Mr. **Ball**. In February 1982.

Mr. **Hughes**. Were you aware of the extent of the chaining at that time?

Mr. **Ball**. No, I was not.

Mr. **Hughes**. At any time that you were with Hutton until you left, in mid-1982, were you aware of the extent of the chaining?

Mr. **Ball**. No, I was not.

Mr. **Hughes**. Did you understand what chaining meant?

Mr. **Ball**. I was told that it was something like check kiting.

Mr. **Hughes**. It was something like check kiting?

Mr. **Ball**. Yes, sir.

Mr. **Hughes**. And what did you understand it to mean, then?

Mr. **Ball**. In a rudimentary sense, Congressman—and I do not pretend to be an expert on this—the deposit of money into one bank with the check written in another bank before you have funds in the second bank.

Mr. **Hughes**. Were there any other indications at any time that extensive chaining was being done, and was brought to your attention while you were still with the company as president and director of the board?

Mr. **Ball**. I don't believe so, sir, no. Mr. Fomon told me that he had been informed by counsel of something that sounded like check kiting, but I'm not sure if he used that phrase.

Mr. **Hughes**. Did he go into any detail?

Mr. **Ball**. He indicated—and I don't remember his exact phraseology—that it was localized or quite local.

Mr. **Hughes**. Well, I think it is important for you to understand from our perspective of what we understood was going on, and you tell me if you understood this to be the practice when it was brought to your attention.

You have a number of branch banks that have checkbooks on different banks around the country, and you make a deposit into a bank in Scranton drawn on a Colorado bank, for instance. And it is going to take several days to clear.

Then you have a special zero balance account, so that when that check comes in, the branch manager has to check with the bank to see what the balance is, and to cover that they have to draw another check. They have another account in a bank in Newark, NJ, and they deposit that into the bank, and follow the same pattern.

Is that what you understood to be the practice of chaining?

Mr. **Ball**. That is a more detailed knowledge of chaining, check kiting, whatever it is called, than I had while I was at Hutton. I have since had it explained to me in that fashion.

Mr. **Hughes**. Were you aware of the fact that they moved several accounts out of New York banks because the checks were clearing too fast, and moved them to Pennsylvania?

Mr. **Ball**. No, I was not.

Mr. **Hughes**. Would that be something that a branch manager would do?

Mr. **Ball**. I don't believe so.

Mr. **Hughes**. Well, there's no question about that, is there? Branch managers wouldn't do that on their own. Branch managers would have no authority to go to a New York City bank and move Hutton accounts to Scranton or anywhere else, would they?

Mr. BALL. These were E.F. Hutton central accounts. No. A branch manager, clearly, would not have had that authority.

Mr. HUGHES. Would a regional vice president have that authority?

Mr. BALL. No.

Mr. HUGHES. Would a regional vice president have the authority to provide checkbooks on Colorado banks, or Kansas City banks, to a branch manager in Kansas City?

Mr. BALL. No. He would not.

Mr. HUGHES. Who would have the authority to do that at E.F. Hutton?

Mr. BALL. The money mobilization department would, I do not know who else.

Mr. HUGHES. Who would have the authority to open up a zero balance or special account for covering overdrafts in New York City?

Mr. BALL. I do not know.

Mr. HUGHES. Did you ever authorize that?

Mr. BALL. No, I did not.

Mr. HUGHES. Would you agree that a branch manager wouldn't open up a special account in New York City?

Mr. BALL. Yes, I would agree with that.

Mr. HUGHES. Or a regional vice president?

Mr. BALL. Yes. That is correct. A regional vice president would not do that.

Mr. HUGHES. Would you agree that to carry out the chaining that took place, it would have to have been done within your department by your personnel?

Mr. BALL. No, I would not.

Mr. HUGHES. Your regional vice presidents did not participate?

Mr. BALL. I am not aware of regional vice presidents having known of the practice or having participated in——

Mr. HUGHES. The testimony is that your regional vice presidents, every day, collected the information from the various branches to see what amount the drawdown was for that particular day, and that was passed on to Washington.

Mr. BALL. I believe that was the regional operations managers who did that, not the regional vice presidents, Mr. Chairman.

Mr. HUGHES. And the regional vice presidents would have no knowledge of that?

Mr. BALL. I believe they would have no knowledge of it.

Mr. HUGHES. Who has direct responsibility over that activity at the regional level?

Mr. BALL. The regional operations managers.

Mr. HUGHES. And who do they report to?

Mr. BALL. In that function they would report to the money mobilizer. They would not report to the regional vice presidents.

Mr. HUGHES. The chair recognizes the gentleman from Florida for five minutes.

Mr. SHAW. Thank you. Mr. Chairman, I want to go back over some of the testimony answers that Mr. Ball gave in reply to some of your questions.

Mr. Ball, you and the chairman appear to have a difference of opinion with the term "overdraft." I have a Black's Law Dictionary which defines "overdraft" as: "the act of checking out more money than one has on deposit in a bank."

Now, based on that definition, I would agree with the chairman, that that would be a question of drawing down not only cleared deposits, not only uncleared deposits, but anticipated deposits that were not presently in the bank. From your testimony, you interpret that "overdraft" is simply pulling down—

Well, let me let you define that rather than my defining it for you. Now, would you give us what you—your definition of "overdraft" as you have used it in your testimony here today?

Mr. BALL. As I understood overdrafting, and as I understood the drawdown system of E.F. Hutton in utilizing overdrafting, it was simply the act of anticipating the availability of funds.

Mr. SHAW. Now this is bothering me.

Now, wait a minute.

Mr. BALL. Yes.

Mr. SHAW. In anticipation of the availability of funds, you mean anticipating what the deposits are going to be?

Mr. BALL. No.

Mr. SHAW. Because I understand that is where E.F. Hutton got in trouble.

Mr. BALL. No. Anticipating the availability of funds that have been deposited—let me underscore that, Congressman—in a branch prior to the time that the local bank would make those funds that have been deposited available to Hutton.

Mr. SHAW. Anticipation as to what time? Are you anticipating what will be in the bank by the time your check hits?

Mr. BALL. No.

Can I just use the rules——

Mr. SHAW. Please do, because I think it is very important that you clarify.

Mr. BALL. If a branch office in Boise, ID, has a client who buys $10,000 worth of stock, the client pays for it, the Hutton office puts the money in the branch's bank in Boise, say that the Boise bank will say, 4 days later, "We'll make this money available," that their practice is, 4 days later to make the money available, rather than waiting 4 days and then saying, "Gee, we will now write a check on that money."

Mr. SHAW. Now, that isn't an anticipated deposit, that is an actual deposit.

Mr. BALL. I'm saying an actual deposit, and I was trying to make it quite clear, Congressman, that I am saying my understanding of the Hutton cash management system and the overdrafting therein had to do with the anticipation of moneys actually deposited, but not prior to their being deposited.

Mr. SHAW. Are you saying anticipation of the funds clearing or anticipation of the deposit?

There's a big difference here.

Mr. BALL. Anticipation of the funds clearing is what I mean.

Mr. SHAW. OK, I think that had to be clarified.

Now, I want to go back to the document that Mr. Hughes was questioning you on with regard to the Washington and Casper operations. This is the memo to you from Tom Lillis on April 23, 1980——

Mr. **Ball**. Yes, sir.

Mr. **Shaw** [continuing]. When it talks about, and it uses the word, "overdraft substantially."

Now, did the Washington operation, which shows a much greater revenue from interest, did their substantial overdrafting include anticipated deposits or only actual deposits? Were they involved in the illegal scheme?

Mr. **Ball**. This Washington office, which is the one managed by Mr. Braelove, was not, as I am told, involved in any of the illegal, or wrongful, or excessive schemes. This is——

Mr. **Shaw**. So, as the term "overdraft substantially" is used in this memo, then it is saying that all you have done is drawn on the funds before they cleared the bank.

Mr. **Ball**. Yes. I don't know what this particular——

Mr. **Shaw**. That's your testimony.

Mr. **Ball** [continuing]. Bank did, but that would certainly be my——

Mr. **Shaw**. That's your understanding of it?

Mr. **Ball**. That is my understanding, that this is an office that did things like that.

Mr. **Shaw**. Do you know of any situations where—or did you know of any situations back when you were with E.F. Hutton—where they were actually anticipating future deposits that were not actually made in the bank and drawing down on them before they were even deposited or put in an envelop to be sent to the bank?

Mr. **Ball**. To the best of my knowledge, no.

Mr. **Shaw**. OK, thank you.

Mr. **Mazzoli**. Mr. Chairman, would the gentleman from Florida yield?

Mr. **Shaw**. I'll be glad to yield.

Mr. **Mazzoli**. I'm interested in what the gentleman was asking about, because in my recollection—and I can't find it in my notes or anything, but it seemed to me one of the branches at some point wrote a check for several million dollars, not for a few thousand and not for, as Mr. Ball had said, some $10,000 that had been deposited or may not have cleared, but for so many, many millions of dollars which bore no relationship in any way mathematically, arithmetically, geometrically, to anything that that particular branch was doing. And so maybe, if I could use the gentleman's time for a second to ask Mr. Ball—

How does that square with your definition of "overdrafting" or handling where you clearly had people writing checks which were not even related in any fashion to money anticipated, on hand, not clearing, or what? How would that be?

Mr. **Ball**. It would not meet my definition—it simply would mean anticipation of the funds clearing out.

Congressman, until well after I left E.F. Hutton, I did not know that any branches had a checkbook of New York checks with which they could, you know, put money into or take money out of a local bank, I was unaware of it.

Mr. **Hughes**. Would the gentleman yield to me further, also?

Mr. Shaw. Yes.

Mr. Hughes. On the same point, if we accept your definition of "overdrafting," it technically isn't an overdraft, because it is a wash on the ledger. If you draw out what is anticipated in the deposit, if you're not drawing out any more than you deposit or you anticipate will be cleared as a result of deposit, that's not an overdraft, is it?

Mr. Ball. Congressman, I believe it is. And please, I'm in a technical area over my head. You can push me on it, but this is not something where I am fluent or conversant.

I believe that if you write a check today, based on a deposit in a bank that has not yet cleared, and by some miracle the check arrives today, there isn't real money there, and, therefore, you have overdrafted. Technically, I could be wrong——

Mr. Hughes. The definition that was read to you by my colleague from Florida is the customary understanding of people about what an overdraft is: it's taking out more than you put in. It's as simple as that.

Haven't you understood that to be an overdraft?

Mr. Ball. That would certainly be a definition of "overdraft," but the definition that I would understand as being overdrafting in the Hutton sense is anticipating the clearance of funds, not taking out more than you put in.

Mr. Hughes. That's what I'm saying.

You're saying you understood overdraft to be taking out no more than you've deposited and you anticipate will clear as a result of that deposit.

Mr. Ball. That is correct, sir.

Mr. Hughes. And that goes on the Hutton's books? Does it go on at the time the deposit is made or does it go on at the time the bank clears the funds?

Mr. Ball. Congressman, I do not know the answer to that. It was not an area of my responsibility. I'm not trying.——

Mr. Shaw. Let me pursue it just a few minutes, as it is a curious term that we're talking about here.

Looking now at the Hutton's books, at what point when a deposit is made—money is received from a customer, the deposit is made—at what point does that go on the Hutton's books? Does it go on at the time the deposit is made or does it go on at the time the bank clears the funds?

Mr. Ball. Congressman, I do not know the answer to that. It was not an area of my responsibility. I'm not trying to evade it, I don't know the answer.

Mr. Shaw. Is the word "overdraft," in the context that you use it, which seems to be at odds with the context of the legal term, is that commonly used in the industry, meaning uncleared funds?

Mr. Ball. I believe so, yes.

Mr. Shaw. I yield back, Mr. Chairman.

Mr. Hughes. The Chair recognizes the gentleman from Kentucky.

Mr. Mazzoli. Thank you very much, Mr. Chairman, and I apologize to the Chair and to the witness for having been here late, and I'm sure a good many incisive questions have been asked. And maybe the questions that I'm about to get into may have already been gone over, but I really need to ask these things, I believe, and to explain to Mr. Ball, who has not perhaps seen or been witness to the information we've had before the committee from Mr. Fomon and other members of your former company, that to say the least they have not been particularly persuasive to me that they did not know what was going on.

I look at this thing maybe not as a money manager or as a Wall Street operator, as one who understands the esoterica of sloshing money back and forth all over this Nation and perhaps all over the world, but as one who, as I've said before, if I happen to write a check for more than my account then has, regardless of what I am anticipating from a client or from a customer or whatever, if I, Ron Mazzoli, write such a check, I'm considered to have written a bad check, simply a rubber check, bouncing that rubber check all around the room.

It seems, somehow, that Hutton has analyzed and rationalized exactly the same thing as being in keeping with the highest ethics of Wall Street, and of the boardroom, and of fiduciary relationships.

Now, let me just ask you in a sort of philosophical sense. Let's assume for the moment that you, as president—not as midlevel executive, not as chairman of your Batavia, New York operation or Louisville, KY, operation, but president of this giant company. Let's just assume for a second you really didn't know what was going on.

Now, let's just ask you, as a former president of that company and is currently active in another industry in the field, how do you see that? I mean, how can you say that if your managers wrote a check at a moment that they knew that there was not funds to cover it at that particular issuing bank, that it was hunky-dory and wonderful and totally ethical?

Mr. BALL. Congressman, it is not my intention to defend the excessive overdrafting or the illegal overdrafting——

Mr. MAZZOLI. I'm not talking about excessive overdrafting, I'm talking about overdrafting. I'm talking about an acknowledgement that if you write a check on a bank, and at that moment you don't have funds to cover it, you suggest that is okay so long as they expect money or so long as there is some far-flung Rube Goldberg kind of arrangement, there are funds sitting around somewhere that could cover it; or, if you sold your headquarters on Wall Street you could liquify enough to cover it.

Am I wrong? Maybe I've missed something in translation.

Mr. BALL. I would not defend—nor do I think Hutton is trying to defend, but let me not speak for Hutton because I do that no longer—the idea of bilking money out of banks that is not there.

My understanding of overdrafting, which may not meet a legal definition, and I am not a lawyer, was that Hutton was writing a check in New York today, to draw down a deposit made in Louisville today. If by some miracle the check arrived, the Hutton check from New York arrived in Louisville today, it wouldn't be money.

Hutton knew, as all companies know, and I think the Federal Government knows, that it's going to take the check, let me say, arguably 3 days to get there, and so rather than waiting until the bank in Louisville says, "Gee, guys, we've made funds available, and then having 3 days worth of slippage," Hutton--and I believe it is perfectly proper from a commercial standpoint—wrote the check in New York today, if it will get to Louisville in 3 days, so as to minimize its loss in float. And I——

Mr. **Mazzoli.** I really salute that. I mean, I think that's wonderful. You are obviously taking advantage of the float, and you're trying to protect yourself, and you're trying to make money on the money. But the little guy who lives in Louisville, who writes an individual check, doesn't have that opportunity. He can't talk about, "Mr. Banker, I'm trying to go for the float and, really, I'm waiting for that check to come in from Batavia, which I'm sure is going to be here in a day or two."

I mean, how is it that somehow big business, which often—and you'll have to excuse me—proclaims its clean skirts and its total objectivity and total ethical stance, is kind of playing the edges, and the little guy can't do the same thing because they nail him? What is the fairness of that? How does that stack up with your fiduciary responsibility?

Mr. **Ball.** I think that the profitability inherent in a large account, whether it be a large corporate account or if you were a rich man, I assume you have the same ability to anticipate funds being cleared in the operation of your banking practices.

Is that right or wrong? I don't know, but I suppose a bank, from the standpoint of profitability will say, "Gee, a large account is going to make us quite a bit of money and we will give them certain latitudes that we will not for somebody with less money."

Again, it's not my job to stand in judgment on that, but philosophically, I suppose that's the rationale.

Mr. **Mazzoli.** Just out of curiosity, at Prudential-Bache do you do any of this sort of thing now?

Mr. **Ball.** No, we do not.

Mr. **Mazzoli.** You do not do excessive overdrafting.

Do you do any overdrafting?

Mr. **Ball.** Our system is a consensual system.

Mr. **Mazzoli.** Consensual.

In other words, if the banks know they're being raped, it's OK, but if they don't know it's not OK?

Mr. **Ball.** No. We arrive at a target balance with banks.

Mr. **Mazzoli.** In other words, you have another sophisticated arrangement at Prudential-Bache; right? Another kind of a variation on the same theme?

Mr. **Ball.** No, we have an agreement with our banks essentially as to the amount of profit they will make from us, and that's an agreement between our money mobilization department and the individual bank, so that through a combination of balances and activities, they will make *x* dollars per quarter or per year, I'm not sure.

Mr. **Mazzoli.** You don't know what's going on to that extent in your company now?

Mr. **Ball.** No, what I'm saying——

Mr. **Mazzoli.** Because you said you didn't understand, apparently, what was going on over at E.F. Hutton.

Mr. BALL. I was not responsible for the practices at Hutton. At Pru-Bache. I'm chief administrative—chief executive officer. And, number two, being somebody who is——

Mr. MAZZOLI. So, you do know what is going on now.

Mr. BALL [continuing]. Not totally stupid, I wanted to make sure that the Prudential-Bache system was one that would be——

Mr. MAZZOLI. So, essentially speaking, I guess what we are saying is, there is another arrangement which you all have now at the new company which, somehow, is another kind of an arrangement here to take advantage of the use of your money by the banks, but it's done consensually so that, basically speaking, this is OK, where if it weren't consensual, it wouldn't be either legal, or ethical, or what is it? I mean, how does this consent change what appears to be more bad checks or rubber checks?

Mr. BALL. We are not writing bad or rubber checks. What we are doing with the bank is saying:

> There's a certain amount of activity in our account, our deposits from our clients will be of about *x* amount. We don't want to have you make us leave $5 million in your bank, because, you see, that's unfair to Prudential-Bache; neither should we be allowed to take more money out of your bank than we are putting into it.

The example that the chairman used, for example, for instance. And, therefore, I think it's something that is—I don't want to say a contract in a legal sense, but it is a compact between the parties, and I think very fair, Mr. Congressman.

Mr. MAZZOLI. Let me ask—I'm, I guess, maybe because my mind is peanut size to try to somehow fathom this global topic, but I still don't see how it's a correct action. I don't have any sympathy for the banks; I mean, I think the way that they are handling the float is wrong, and that has produced a lot of reaction in your industry and others, and I think, in the end product, that is the basic culprit in this whole scheme. But, nonetheless, I still worry about this arrangement which I cannot follow.

Let me just wind my time——

Mr. HUGHES. Would the gentleman yield to me?

Mr. MAZZOLI. Yes.

Mr. HUGHES. I don't want to really prolong this, because the investigation is on E.F. Hutton, but I might say to my colleague that one of the things, apparently, that Prudential-Bache has done, is enter into a consent with the bank, something that was absent in E.F. Hutton. And it is not unusual for banks to permit even known individuals in a community, if they have a check drawn on another bank and they are a responsible citizen, they'll quite often permit it to be put through as cash, that's not unusual—and you're actually anticipating collection. And that is quite proper under those circumstances.

It does trouble me, and I share the gentleman's concern, about what banks are doing these days. Sometimes if you deposit a check in a bank drawn on a neighboring bank, they won't give you a free balance for 10 days.

Mr. MAZZOLI. Sure. I think if my friend would yield, I think what we're talking about is big guys leaning on little guys. If the big guy is big enough that he can lean on someone slightly smaller, then you get anything you want; if the little guy is leaning against the big guy, then it's a bad check. If the little guy gets leaned on, it's great, it's just taking advantage of the opportunity.

I won't say that's wrong. I mean, life is a series of big guys leaning on little guys, but I'm not sure that that's the way Wall Street or big business ought to—

And I appreciate the chuckles in that row of people behind you, probably your advisors; but I don't think it is particularly seemly. But that is their decision to make. I'm making a point that I think is important to be made to the people of America watching the show, and that is that big guys leaning on little guys get anything they want and it's all squared away because it's consensual, but the little guys don't get the same opportunity. That's the only point I'm making.

Let me go to one thing, Mr. Chairman, if I could just go on to one other area, and I'll wind up.

You mentioned at some point that you're a prolific writer, and I think that's great, because in today's society mostly it's words, and I think it's great that people write. And you've written memos, and the staff has compiled several exhortations, probably, to your sales people.

Mr. BALL. Yes, sir.

Mr. MAZZOLI. And that's where I picked up the name Batavia from wandering through some of them, and you have some other medium to small cities. And in your various memos, I mean you pick up—you rate them as "excellent, good, fair, and poor" with respect to their performance per month, in your activity as a sales manager in sales action. And you rate, for example, in April 1981, Chicago, Gateway, Grand Rapids, Lansing, and Peoria, in this particular district, as excellent; and poor, Southfield and Chicago National Commodity.

In October 1981, also, you have as excellent cities like, in another zone, Cincinnati, Cleveland, Garden City, Batavia, Buffalo. And then you have as poor: 40th Street, Stamford. You have fair: Erie, Shrewsbury. You obviously had a pretty good knowledge of who was doing what and where they were doing it. I mean, you had a pretty good fix on your sales managers and who was humping and who was sitting in the shade and relaxing.

Let me go back again to sort of a philosophical thing: How it is, then, that we should be persuaded that sitting in your area on Wall Street, you did not know what was going on in something that was millions, and millions, and millions of dollars worth of gain and loss, where—I think my figure was correct—there was something like an $8 or $9 million check written, so that it was obvious the scheme got to be so carried away that these checks bore no relationship to income or outgo, they were just checks. I mean, they were just—if you want to earn $100,000, then you just wrote a check big enough to earn $100,000. It was kind of pretty easy money, really.

Let me ask you again: How is it that you and Mr. Fomon, everybody, has denied—I will use the term born in my days on the Intelligence Committee of "plausible deniability." Why would I then—and let me just ask you this question: Why would I, as a sane, sensible human being, not be permitted the logical conclusion, that this arrangement was concocted, contrived and set up to be plausibly deniable by everybody in the chain, with the exception of those people who Mr. Fomon scorned as poor ones making just $40,000 a year, which, for where I come from, is a pretty heavy income. But those poor guys or ladies at the end of the line, they are the ones, the scheming, wily, canny people, and illegal at that. But we at the top of the line don't know anything that's going on.

Now, you knew enough to know what Batavia and 40th Street were doing. How come you didn't know what was going on with billions of dollars involved?

Mr. BALL. I did a quick review of the 300-and-some-odd actually mainly normal branches in E.F. Hutton at every month, looking basically just at their aggregate profit, and I would dictate, "Excellent," "Good," "Fair," "Excellent," "Good," "Good," just looking at the profit figure, net profit. At times I would see a sheet that would have operating income, operating expense, interest profit, employee benefit costs, net profit, and would digest it literally as rapidly as that. And having done it for 10 years, I had a pretty good horseback sense of, "Hey, does it look good?" "Does it look bad?" There wasn't a lot of science in it.

Mr. MAZZOLI. And so you pick up a certain amount of handsome body language, a few little shortcuts, to decide who's doing what; right?

Mr. BALL. No, I'm not talking about hints or body language, I'm just talking about looking—just looking at numbers. After a while you become——

Mr. MAZZOLI. Well, you pick up a few figures, you know.

Mr. BALL [continuing]. You become comfortable with them.

Mr. MAZZOLI. Sure.

Mr. BALL. In the kind of month that the firm had, was a profit of $20,000 good or bad, just on a sensory basis.

Mr. MAZZOLI. You'd pick up little hints here and there.

Mr. BALL. Yeah, as I had said before you came in, Congressman, I wasn't the person to whom the money mobilizer——

Mr. MAZZOLI. Nor was Fomon, nor was Lynch, nor was anyone. We accept that for the record, that nobody is responsible, nobody knew what was going on.

Mr. BALL. The difficulty from my standpoint is that a number of people have come in and said, "I was not the one responsible;" and being the 4th, or the 14th, or one of the latter ones saying that I'm sure stretches the patience of the committee. However, I was not, and I think the testimony, what have you, has shown that I was not aware of or responsible for——

Mr. MAZZOLI. You know, if you can pick up what Batavia is doing or what Louisville, KY, is doing, and people would say that those are the hinterlands or something—I don't, but they do—how come you couldn't pick up a little hint, a little body language, or bottom-line number, or some evidence, some kind of inkling, that what you're exhorting these people to do, which was to maximize interest income, you were exhorting them month, by month, by month, prodding them, pushing them, challenging them, inspiring them. Why didn't, somewhere along the line, no one picked up billions of dollars?

You'd pick up a half a hundred from Louisville but not a billion. I don't understand. I don't understand it.

Mr. Ball. Two points, Congressman. One, there are several occasions in the memoranda that have come to the committee that show that on several occasions I did ask questions: "Why is interest profit here so high?" Why was something else, you know—"Was there an accounting glitch," whatever?

Mr. Mazzoli. I think the aspect of those questions was to salute the ones who were high and challenge the ones that were low, not so much to ask how the high got high, though.

Mr. Ball. Yes, I would salute the high.

Mr. Mazzoli. I see my chairman is getting the big hook out for me, I guess I've outlived my welcome even in my own committee. But let me just say I thank you very much for coming. I'm sure this is not an easy experience for you and for the other executives.

But let me just say I think that one way—you know, one little rule of thumb. A lot of times in politics we pick up rules of thumb, and, you know, sort of like cookie-barrel philosophy. One thing that—we have all kinds of rules on the books, ethical rules, ethics in Government, disclosures, and all this kind of thing. But when you come right down to brass tacks, nothing is more infallible and a better guide to your conduct than the very simple admonition, how would it play on the front page of some newspaper? And I hope that whatever is being done in Wall Street as an institution, as an industry, and whatever is being done now at E.F. Hutton and at Prudential-Bache or everywhere else, is in some connection with that feeling, how would it play on the front page? Because if it's a Rube Goldberg kind of "in one door and out the other," or Mack Sennett kind of a crazy affair, trying to explain that on the front page of the paper isn't going to be very persuasive to the sort of thing, how does it play in Peoria?

So, I think an end product, if this is, in fact, something which you did not know, and Fomon didn't know, and Lynch didn't know, and no one knew, and that the people really responsible were those horrible, mean, vicious, conspiring people at the $40,000 level, not at the half-million dollar level, well, then, I can only say that it still doesn't play very well on the front page, and I would just say that—and it is my last statement—that maybe that might be as much of an indication to the business community, is to say, "How does it look on the front page?" And if it doesn't look good, don't do it.

Mr. Ball. I would agree with you, Congressman——

Mr. Hughes. The gentleman's time has expired.

Mr. Ball [continuing]. In fact, that the Justice Department's investigation and this subcommittee's investigation, although clearly something uncomfortable from the standpoint of E.F. Hutton and, let's say for business generally, has been constructive from that standpoint.

Mr. Hughes. Thank you. I appreciate that.

I just have a couple of other lines of question.

You still have the memo from Lillis to you, April 23, 1980?

Mr. Ball. I do, sir.

Mr. Hughes. Mr. Ball, one of the reasons why I have great difficulty with your testimony, insofar as you didn't know the significance of "overdraft substantially," is that any businessman reading that has to understand the significance.

I refer you to Casper—I presume that's Casper, WY.

Mr. BALL. Wyoming? I would think so, sir, yes.

Mr. HUGHES. A fairly small community?

Mr. BALL. I have not been there, but I would assume so.

Mr. HUGHES. That general ledger interest, almost entirely due to BOA drafts outstanding and overdrafting, $24,400—$24,400. That's for the month. Now, this is back in 1980.

And you are made aware of that; are you not?

Mr. BALL. Yes, sir.

Mr. HUGHES. In 1980.

Now, the significance of that is that in order to generate that kind of interest income through overdrafting, presuming interest was about 12 percent—

And that's modest, I would think, in that period of time; wouldn't you agree—12 percent interest?

Mr. BALL. Yes, sir. That's probably higher at that point in time.

Mr. HUGHES. I say, it's very modest. I'm just using 12 percent.

You'd have to have overdrafting of $2.4 million every day, every day for 30 days.

Referring you over to the Washington office. I presume that's Mr. Bacon's office. And that general ledger——

Mr. BALL. Sir, no, that is not Mr. Bacon's office. The office referred to in this, having been given this sheet and some backup sheets——

Mr. HUGHES. Is it the other Washington office?

Mr. BALL. Yes, sir.

Mr. HUGHES. OK, whichever one it is.

Net general ledger interest almost entirely due to BOA drafts outstanding and overdrafting, $47,500, just about twice that.

In the memo from Mr. Lillis, he is telling you that the reason for the excess is overdraft substantially—overdraft substantially—through Bill Sullivan in New York.

Didn't that put you on notice as to what activity was taking place in those offices?

Mr. BALL. It did not put me on notice of any wrongful activities in those offices; nor, Mr. Chairman, I am told, was there wrongful activity in those offices.

Mr. HUGHES. But, Mr. Ball, you are the president of the company, you are a very bright guy or you wouldn't be president of the company. You're on the board of directors. You are charged with responsibility of being the head of a company. You are in charge of maximizing interest profits. And you mean to tell me you don't understand the significance of that?

Mr. BALL. I understood the significance and saw—and see today—Mr. Chairman, nothing wrong with what is outlined in this memorandum.

Can I add just one thing, sir, very quickly?

I clearly—as it says here, it was requested that I answer your, George Ball's, question regarding the interest income of the Casper and Washington offices. So, I was obviously asking, I would think, why is the income so high?

Mr. Lillis points out that there is no breakdown available as to how much of the interest profit relates to Bank of America drafts and how much relates to overdrafting. I believe that is stated in the memo. And he says that 20 percent interest, which I presume was the then prevailing rate, the process of drawing down or overdrafting substantially is quite profitable but seems plausible and factual to me, sir. I'm sorry.

Mr. HUGHES. Wouldn't it be your responsibility as the president of the company, the one charged with trying to maximize interest, to find out what was maximizing interest profits? Shouldn't that be part of your responsibility?

Mr. BALL. Sir, two things. I was not, quote, "the one responsible for interest profitability in Hutton." I was responsible for the branches, and, therefore, for their interest profit. Second, in asking the question about these, I think I was making inquiry, frankly.

Mr. HUGHES. What profit did you ask for a report on in the two offices?

Mr. BALL. Sir, I don't remember at this time. I would infer that it is because the interest profit in each of the two was quite high.

Mr. HUGHES. Let me see just why you ask. You ask because these offices were reporting tremendous interest profits at a time of high interest, and you wanted the other branches in the other regions around the country to try to duplicate that; isn't that so?

I have a whole host of memorandums I'll be happy to read to you, where you are the super salesman. You're saying, "You know, your region is really below norm. You take a look at what central is doing. You ought to be talking to Tom Morley. You ought to be talking to Sullivan."

So, what you were doing, in essence, is you were saying to the other regions, "Hey, guys, look what's happening over here in Washington and Casper, WY, and you ought to be taking a look at what they're doing." Isn't that what you were saying?

Mr. BALL. I did direct people in Hutton to Mr. Morley, who is their interest profit expert, to Mr. Mohan as their communications expert, et cetera.

And Congressman, again—excuse me for saying it once more—I am told that neither Steve Braelove's Washington office nor the Casper office at this point in time were doing anything regarded as excessive or wrongful. I am—my counsel has been told that.

Mr. HUGHES. Well, I'm not so sure that I'm prepared to accept that, I don't care what your counsel told you. The fact of the matter is that they were generating huge interest profits.

Mr. BALL. Yes, sir.

Mr. HUGHES. Mr. Bacon's office was generating tremendous profits, depositing $70,000, drawing down $7 million.

Mr. BALL. Again, this is not Mr. Bacon's office that is referred to here.

Mr. HUGHES. I am not referring to this office, I'm referring to Mr. Bacon's office, Mr. Bacon's office, depositing $70,000, $80,000, drawing down millions of dollars, no relationship to what was being deposited, and it was generating huge profits. And you were saying to the various regions, "Take a look at what is happening in these other offices. We want you to do the same thing."

Is that what you were saying?

Weren't you saying to these other offices, "Hey, look at what central is doing, and you guys ought to get on the stick and you ought to do the same thing." Weren't you saying that?

Mr. BALL. No, sir. I was, in memorandum form, directing people to Mr. Morley as the interest profit ghuru of E.F. Hutton & Co., I was not referring him to the central region——

Mr. HUGHES. Well, the fact of the matter is that these offices were making tremendous interest profits through an illegal scheme. Any question about that?

Mr. BALL. And I would not defend those——

Mr. HUGHES. No, no. That's not my question. I'm not asking you to defend anything.

Isn't that a fact——

Mr. BALL. Yes, sir.

Mr. HUGHES [continuing]. That some of these offices were engaging in an illegal scheme which led to 2,000 counts of wire and mail fraud, criminal wire and mail fraud, and the corporation was convicted of that?

Mr. BALL. Yes, sir.

Mr. HUGHES. And those practices were within your shop. They were carried out by the branch offices, the regions. They had to carry it all out. That's within your shop.

Mr. BALL. Sir, the money management practices and policies and oversight thereof were not within my reporting venue.

Mr. HUGHES. Yes, but I'm saying that these are the people that—their line of command was to you. The regional vice presidents reported to you, did they not?

Mr. BALL. Yes, they did, sir.

Mr. HUGHES. And they had, basically, overall responsibility in the various regions, I presume, according to the charts.

Mr. BALL. They did not have the responsibility directly or indirectly for the money management practices, Mr. Chairman.

Mr. HUGHES. Well, the fact of the matter is you pointed, wittingly or unwittingly, to these illegal practices and said, "Duplicate them." You said, "Look, they're making tremendous profits in the central region, and the other regions ought to take a look at what they're doing."

Mr. BALL. I don't believe I did refer anybody to the central region. I could be wrong, sir. Again, with 25,000 memoranda around, I promise you I do not recollect them all, but——

Mr. HUGHES. I'm going to show you a memorandum which is dated March 19, 1982, and ask if you've ever seen this before. It's attached to an analysis of net interest income.

Have you heard the term "aggressive overdrafting" before?

Mr. BALL. I have seen it, having seen this memorandum previously in preparation for this testimony, sir.

Mr. HUGHES. Did you understand what the term "aggressive overdrafting" meant back in 1980–82, that timeframe?

Mr. BALL. I'm not sure today, Congressman, much less then, what "aggressive overdrafting" meant. If it means aggressive efficient there is a positive connotation, if it means aggressive beyond the lines of propriety, there is a pejorative connotation. So, I'm not sure of the—It would probably sound like something that's too much.

Mr. HUGHES. Take a look at the analysis of that interest income prepared by Margaret Zulich, March 1982. Have you seen that before?

Mr. **Ball**. Yes, I have, sir.

This memorandum that you just gave to me?

Mr. **Hughes**. Yes. Without objection I'm going to offer this for the record.

[The document referred to follows:]

EF Hutton & Company, Inc.,
One Battery Park Plaza,
New York, NY, March 19, 1982.

Memo from: George L. Ball.

TPL—Note commentary—seems very aggressive. Who was calling the shots, and were the shots well called?

George.

Enclosure.

Analysis of Net Interest Income

(By Margaret Zulich, March 1982)

I. INTRODUCTION

During the analysis relating to the Midwest Regional Planning Meeting, interest profits for the Midwest Region versus those of other regions became an issue of great concern. Corporate Development, therefore, agreed to analyze the components of interest income and expense.

The objectives of this analysis are twofold. The first objective is to analyze the regional differences in the components of net interest income, primarily to determine, statistically, the causes of the Midwest Region's below average interest profits in 1981. The second objective is to develop a prototype for the periodic reporting of net interest income.

Prior analysis has shown a similarity of results for interest profit on an annual basis compared with the results of a single month. Based upon these results, and given the volume of clerical effort necessary to analyze the components of net interest income on a regional basis, the month of November, 1981, was selected as a representative sample. Interest revenues and expenses were examined for the interest month of October 15 to November 14, which is reported on the November P&L. This analysis was restricted to the retail regions as reported on the *Regional Profit and Loss Statement*. It examines interest, statistically, from the retail region's perspective. It does not comment on EFH accounting procedures, nor does it examine the firm's cost of money, but it looks only at the interest the firm charges/credits to the region. It does not make any specific recommendations as to operational changes which might increase interest profits; however, it does call attention to areas where operational or procedural analysis is warranted.

For purposes of this analysis, interest profits are separated into three distinct areas:

a. Interest earned on margin balances; b. Interest earned on general ledger balances; and c. Interest earned on cash balances in customer accounts.

This analysis utilized various sources of information already available. Sources for this analysis included:

November 1981, Regional Profit and Loss Statement; November 1981 Business Unit Profit and Loss Statement; MF-5 and R-1 Reports, November 1981; Normal Interest—General Ledger Report; Normal Interest List—Customers; Type 1 Interest; Interest Analysis on Customer Balances; and Quarterly Account Executive Commission Report (QUAECR).

EF HUTTON.—AN ANALYSIS OF INTEREST EARNED ON GENERAL LEDGER BALANCES, NOVEMBER 1981

[Figures in percent]

	Total Interest Earned on General Ledger Balances		Interest Earned on Drawdown		Interest Earned on Customer Payables		Interest Earned on all Other General Ledger Accounts	
	Percent Int.-Sens. revenue	Percent Better/(Worse) than average	Percent Int.-Sens. revenues	Percent Better/(Worst) than average	Percent Int.-Sens. revenues	Percent Better/(Worst) than average	Percent Int.-Sens. revenues	Percent Better/(Worse) than average
Atlantic	8.5	10.4	3.6	56.5	4.7	(6.0)	0.2	(50.0)
Central[1]	17.4	26.0	13.3	478.3	4.2	(16.0)	(0.1)	(125.0)
Midwest	7.2	(6.5)	1.5	(34.8)	5.2	4.0	0.5	25.0
Mountain	8.5	10.4	1.6	(30.4)	6.2	24.0	0.6	50.0
New England	7.3	5.2	1.4	(39.1)	5.4	8.0	0.5	25.0
Pacific North	5.5	(28.6)	0.4	(82.6)	4.7	(6.0)	0.4	0.0
Pacific South	5.0	(35.1)	0.6	(73.9)	4.4	(12.0)	0.0	(100.0)
South Central[2]	8.5	10.4	2.9	30.0	5.2	4.0	0.4	0.0
Southeast	7.0	(9.0)	0.7	(69.6)	5.5	10.0	0.8	100.0
Retail Firm	7.7		2.3		5.0		0.4	

[1] The Central Region's high interest earned on overdrafting was due to temporary aberrations in banking policies.

[2] Adjusted to exclude prior period adjustments made in November. These entries reduced total interest earned on general ledger balances and interest earned on overdrafting to 3.7% and (1.9%), respectively.

CENTRAL REGION INTEREST EARNED ON DRAWDOWN NOVEMBER 1981

[Figures in percent]

	C18	C20	Central Region	Retail Firm
Interest on drawdown as percent interest sensitive revenues	61.3	291.4	13.3	2.3

Drawdown procedures in the Central Region deviate from those of other regions. The Washington (C16), Washington II (C18), Baltimore (C17), Norfolk (C25), and Bethesda (C32), offices are drawn down by New York directly. Moreover, the regional concentration account and the Kansas City bank account are commingled. Therefore, the regional interest earned on drawdown for all offices, other than those drawn down by New York, is credited to the Kansas City retail office. (Recently, the region changed its procedures. The Kansas City and regional concentration accounts are now separate.) For the month of November, interest earned on drawdown as a proportion of interest-sensitive revenues amounted to 15.4% for the Kansas City branch.

In addition to the Central Region, the Atlantic, Mountain and South Central Regions surpass the firm average in interest earned on general ledger balances. Aggressive drawdown supported the Atlantic Region's position, while the float earned on BOA drafts buoyed the Mountain Region.

Both west coast regions reported below average interest on general ledger balances. Because BOA drafts are drawn on a California bank, west coast offices would necessarily benefit less from their use, as evidenced by the lower interest earned on customer payables. However, both these regions fall below average in interest earned on drawdown as well.

The Midwest Region reported general ledger interest below the firm standard. While the interest earned on the use of BOA drafts exceeded firm average, the Region reported below average interest earned on drawdown.

Several noteworthy Midwest offices include:

Lansing and Rock Island stand out with exceptionally good performance. Both offices earned significantly above average interest on customer payables, with Lansing also above average on drawdown.

Mr. HUGHES. The commentary on here would appear to be from you. It is a memo from George L. Ball, dated March 19, 1982: "Note commentary—seems very aggressive. Who was calling the shots, and were the shots well called?"

Mr. BALL. Yes, sir.

Mr. HUGHES. What does that refer to?

Mr. BALL. In the body of a memo that I think was 25 or 30 pages, and this is an extract therefrom if I am correct, there is a breakdown of the interest earned on the drawdown by E.F. Hutton.

To my knowledge, by the way, it is the first time that Hutton ever segmented the interest earned on drawdown from the interest earned on Bank of America drafts. It's the first time that the firm did it, to my knowledge in any event.

The interest on the drawdown as a percentage of so-called interest sensitive revenues of two offices are set forth, and I sent a note that is in my handwriting to TPL, who would be Thomas Lynch, the chief financial officer of Hutton, saying, "Tom, note the commentary which is the aggressive drawdown seems very aggressive. Who is calling the shots and were the shots well called?" So, I was questioning the propriety of the activities that would have resulted in interest on the drawdown that was that high.

Mr. HUGHES. What triggered your concern in particular?

Mr. BALL. I don't remember now. Having seen the memo, though, if you want me just to infer.

Mr. HUGHES. Well, if you remember.

Mr. BALL. I don't remember what I thought then, but the interest on the drawdown in the offices cited are very high, very high relative to its region, very high relative to the firm, and, therefore, I wanted to ask whether or not they were proper; which is what I did—"It seems very aggressive, who is calling the shots, and were they called well?"

Mr. HUGHES. You're referring to the central region and the fact that the interest earned on drawdown was 478.3 percent over the average.

Is that what that says, 478.3 percent?

Mr. BALL. No, sir, I don't—

Could you give me the page of the document?

I do not see that, I'm sorry.

Mr. HUGHES. The previous page.

Do you have the previous page, where you have a handwritten note?

It looks like your writing.

Mr. BALL. The one that says, "E.F. Hutton An Analysis of Interest Earned on General Ledger Balances"?

Mr. HUGHES. That is correct, November 1981.

Mr. BALL. Yes.

Mr. HUGHES. Is that your handwriting at the top?

Mr. BALL. Yes, it is.

Mr. HUGHES. And does it have an arrow from the "126 percent"——

Mr. BALL. Yes, sir.

Mr. HUGHES. And the general ledger balances?

Mr. BALL. Yes, sir.

Mr. HUGHES. Moving over under "Interest Earned on Drawdown, 478.3 percent" above average?

Mr. BALL. Yes, sir. Right. I see that now. Yes.

Mr. HUGHES. Well, isn't it a fact that that's what triggered your concern?

Mr. **Ball**. As you see, there is a handwritten note from me, which I think is just a note of my own, saying "too much; has to be wrong." The amount by which it exceeds the firmwide average is too much——

Mr. **Hughes**. What did you think they were doing to get that kind of a percentage above average?

Mr. **Ball**. Sir, I didn't have any idea or I wouldn't have, for example, asked Tom Lynch about it. I didn't know.

Mr. **Hughes**. As president of the company do you think that it was your responsibility to find out?

Mr. **Ball**. I did ask the question, sir. This is the first time——

Mr. **Hughes**. And what did you find out?

Mr. **Ball**. Pardon?

Mr. **Hughes**. What did you find out?

Mr. **Ball**. I do not recall getting——

Mr. **Hughes**. Did you follow up on it?

Mr. **Ball**. I do not recall getting——

Mr. **Hughes**. Did you ever find out from Tom Morley what he was doing to maximize interest profits in generating so much——

Mr. **Ball**. I did not see the need to keep a followup file on the thing.

Mr. **Hughes**. Did you ever talk to Tom Morley about it?

Mr. **Ball**. No, sir; I did not.

Mr. **Hughes**. Did you ever talk to Tom Morley?

Mr. **Ball**. I spoke to Tom Morley about the establishment of Hutton's cash management account, about their commercial paper business. I did not talk to him about their drawdown system.

Mr. **Hughes**. Did you ever find out from Tom Morley what he was doing to maximize interest profits in generating so much revenue?

Mr. **Ball**. No, sir, I did not. And actually, I think Mr. Morley testified——

Mr. **Hughes**. Weren't you ever curious about——

Mr. **Ball** [continuing]. That he didn't talk to me about that.

Mr. **Hughes**. Weren't you ever curious about how he was generating so much interest profit?

Mr. **Ball**. Interest profit came from a number of sources, as you well know, sir. In terms of the drawdown system, I had no curiosity to speak of, because it struck me, again, as a glass that could be emptied, and, therefore, a mechanical procedure.

Mr. **Hughes**. Well, I have some curiosity about that.

On April 27, 1981, you wrote to the regional vice presidents and sales managers along the following line, and I quote:

> Along the way each region or each manager would be well advised to contact Tom Morley and his associates for assistance in maximizing the net interest income from their activities. Tom knows a number of ways in which to help branches derive a proper share of the profit from the funds which flow to and through them.

What kind of activity were you talking about?

Mr. **Ball**. Could you——

Mr. **Hughes**. What was Tom doing that you were trying to get them to duplicate?

Mr. **Ball**. Mr. Chairman, I do not know what Mr. Morley was doing in a business sense to have the cash management system operated or the procedures installed. What I did know was that he was Hutton's interest profit czar and that I was encouraging, exhorting if you would, the branches to talk with the firm's in-house expert to derive—and I would point out the word "a proper share"—of the funds that flow to and through them.

Mr. HUGHES. Well, you served on the board of directors during this period of time.

Mr. BALL. Yes, sir.

Mr. HUGHES. Don't you think it was your responsibility to find out where profits were coming from and how they could be maximized? Isn't that part of your responsibility as a member of the board?

Mr. BALL. To the level of detail of the drawdown system at that time, Mr. Chairman, I would not have thought so. I was unaware that there were things that could be done to gain enlarged shares of interest income from a drawdown system.

I was aware that other activities like client short-sales or margin accounts could add to interest income, and that they were sales derivative and of some interest.

Mr. HUGHES. Well, you would have us believe that the system was pretty much mechanical, that is that there was a drawdown sheet, you didn't know too much about it, that there was some system to maximize interest profits.

Is that a fair characterization?

Mr. BALL. That is my understanding, sir, yes.

Mr. HUGHES. If it was so mechanical, what were you asking your subordinates to do to increase their interest earnings?

Mr. BALL. In things that are mechanical, you can either do them well or poorly. There is no doubt but that—just to use a slightly different example—if Hutton gets a stock certificate into a branch and doesn't get it to New York quickly, a mechanical procedure, that costs Hutton a lot of money. It's boring, routine, and it's mechanical, but it's also important. So, there is a difference between efficiency and inefficiency that certainly is important in a number of things that a securities firm does.

Mr. HUGHES. On June 17, 1981, you wrote a number of notes on a letter from John F. Duncan, president of Hutton Credit, including one that said, and I quote:

> Are you comfortable with internal cash mobilization practices at Hutton Credit? The securities company has a super cash manager, Tom Morley, whom you might want to use to review handling of float, bank balances, temporary investments.

[The document referred to follows:]

[Memorandum from E.F. Hutton & Co., Inc., New York, NY, June 19, 1981]

To: John Duncan.
From: George L. Ball.

A couple of questions.

(a) Are you comfortable with internal cash mobilization practices at Hutton Credit? The securities company has a super cash manager (Tom Morley) who you might want to use to review handling of float, bank balances, temporary investments, etc., if not

(b) I think short term rates will fall somewhat more. If and when they do, do you want to look at possibly changing the matching of lease terms and debt to bring the two somewhat more closely in line? Am not "pushing" on this, just curious as to your predilections.

(c) Is the $1.4 million of "miscellaneous" income in May largely the Pullman buyout?

E.F. HUTTON CREDIT CORP.,
Greenwich, CT, June 15, 1981.

Re Operating Results and Comments/May.

Messrs. ROBERT M. FOMON, GEORGE L. BALL, THOMAS P. LYNCH,
E.F. Hutton & Co., Inc.,
New York, NY

Gentleman: Sales Volume for the month was $21.8 million, 6% above Budget and 117% over 1980. Year-to-date sales are 7% below Budget but 9% over 1980's actual. Sales outlook near term remains mixed due to continued high fixed interest rates. Sales for June should be on Budget.

Revenues for May were $5,838,000 compared to a Budget of $4,537,000 and $3,295,000 for May 1980. Net Income for the month was $678,000 ($610,000 for the May 6–31 period) compared to a Budget of $521,000 and May 1980's actual of $320,000. Year-to-date earnings are $2,498M vs $1,736M for the same period 1980. Current earnings are being adversely affected by abnormally high money costs. The substantial May 1981 increase in revenues and income resulted from the Pullman Inc. buy-out of a leverage lease which netted $893,000 in revenues and $250,000 in net income.

Dollar delinquency at month-end was 1.6% compared to 1.4% at April month-end and 1.8% at month-end May 1980.

Interest expense for May was $3.4 million, an increase of $350,000 from April's expense level. Commercial paper costs averaged approximately 300 basis points higher than April and coupled with an up turn in business volume, caused the increased interest expense in spite of the cash contributed for tax benefits by IPCo. on May 6. The attainment of intermediate term debt is an immediate necessity one to the preponderance of short term debt in our capital structure.

E.F. HUTTON CREDIT CORP. CONSOLIDATED STATEMENT OF INCOME AND RETAINED EARNINGS

[In thousands]

	For the month		For the year-to-date	
	May 1981	April 1981	1981	1980
Earned income:				
Financing and lease	$3,286	$3,105	$14,666	$9,720
Amortization of investment tax credits	35	544	2,170	2,104
Interest	1,071	1,089	5,614	3,590
Miscellaneous	1,446	230	2,077	174
Total earned income	5,838	4,968	24,527	15,588
Expenses:				
Operating and administrative	967	1,250	5,095	3,528
Provision for Losses	274	253	936	651
Interest	3,437	3,085	16,047	10,012
Total expenses	4,678	4,588	22,078	14,191
Earnings before taxes	1,160	380	2,449	1,397
Income tax expense (Benefit)	482	(86)	(49)	(339)
Net earnings	678	466	2,498	1,736
Retained earnings, beginning of period	17,796	17,355	16,001	10,590
Total earnings	18,474	17,821	18,499	12,326
Less: Preferred stock dividend	0	(25)	(25)	0
Retained earnings, end of period	18,474	17,796	18,474	12,326

Mr. HUGHES. What is it that Tom Morley was to teach to the branches and the regions and the credit corporation?

Mr. BALL. Mr. Chairman, if I had known what he was going to teach, then I might well, at some point, have taught it myself. And I don't mean that facetiously. I did not know, technically, what he did. Had I, probably at some point I would have written a memo about it.

Mr. Duncan was the head of the Hutton Credit Co. which had been recently acquired by E.F. Hutton. I had been in a meeting with him. He sent a note concerning how Hutton Credit was doing, and since a credit company is very sensitive to the flow of funds, I suggested that he see Mr. Morley, of whom I had heard very good things said by the operations and administrative people at Hutton.

So, again, I was directing Mr. Duncan to Mr. Morley as Hutton's expert for advice and counsel.

Mr. **Hughes**. Well, it's interesting, because, once again, you're telling us that you didn't know what the system was, you just told him to use the system.

Mr. **Ball**. I told him to consult with the person who understood and could teach him the system.

Mr. **Hughes**. Mr. Ball, aren't you telling him to use the system, to look at the system? Isn't that what you are saying? Aren't you saying, "Tom Morley is a super money manager, talk to him about the system"?

Mr. **Ball**. I am telling him to learn about the system and then presumably to use it, because if it's good, having learned it, it should be.

Mr. **Hughes**. Well, isn't that what I asked you, if you're not telling him to use the system?

I mean, you're the president of the company. If the president of the company says "I want you to take a look at this," I think the chances are that those subordinates below you are going to take a good, serious look at it and they'll be implementing it very shortly.

Mr. **Ball**. Certainly within the retail sales organization, yes. As to the credit company, whether what Mr. Morley did or not I wasn't sure.

Mr. **Hughes**. You were a prolific memo writer. I mean, you were always sending memos out, encouraging your subordinates. You were a chief cheer-leader at E.F. Hutton, telling them to replicate what was happening in the Central region.

Mr. **Ball**. No, sir; again, I don't think I told them to replicate what was happening in the Central region, per se.

Mr. **Hughes**. I'm going to show you a memorandum from yourself to John Latshaw, dated February 25, 1982, and ask if you have ever seen that before.

Is that your memo?

Mr. **Ball**. Yes, it is, sir. It is one of my regional monthly commentary memos.

Mr. **Hughes**. Now, let me just try to quickly summarize for you. As I understand it, this memorandum is an effort to show John Latshaw—and, I presume, for him to disseminate to his subordinates—the fact that the following branches were excellent: Alexandria, Baltimore, Louisville, Washington I, Washington II. Poor: Des Moines, Lincoln, Nashville, Norfolk, Omaha, and others. And some were good and others were fair on that list.

Mr. **Ball**. Yes, sir.

Mr. **Hughes**. "Incidentally," you say, "isn't it time we stopped talking about new leadership in Nashville and started doing something about it?

"As you well know, the results in your region were far from outstanding. However, the example set by Alexandria, Baltimore, Louisville, Washington I, and Washington II demonstrated that strong leadership and determination can overcome even the most adverse conditions. Please do everything possible to get your lagging branches to emulate them."

Mr. Ball. Yes, sir.

Mr. Hughes. Well, you just suggested to me that you didn't do that.

Mr. Ball. This is to John Latshaw, who is the regional vice president for the Central region. This is a commentary on the branches.

Mr. Hughes. And it went to Ernie Dippel.

Mr. Ball. Who is his regional sales manager, as is——

Mr. Hughes. And G. Irish.

Mr. Ball [continuing]. Gary Irish, who is also the regional sales manager.

Mr. Hughes. And that wasn't shared with any other regions?

Mr. Ball. No, sir.

Mr. Hughes. Well, you're telling John Latshaw, "Please do everything possible to get your lagging branches to emulate them." What does that mean?

Mr. Ball. He, according to my evaluation of the profit figures in that particular month, had a group of offices that did quite poorly in terms of the net bottom line. He had others that did quite well in terms of net profit. And I was saying that the bad branches shouldn't be bad, get them to do a better job——

[The information follows:]

[Memorandum from E.F. Hutton, Feb. 25, 1982]

To: John Latshaw.
From: George Ball.
Subject: January Performance.

In January your region stood 5th of the 9, excluding International. Noted below are my perceptions of the performance of each of your offices:

Excellent: Alexandria, Baltimore, Louisville, Washington I, and Washington II.
Good: Kansas City.
Fair: Bethesda, Clayton, Knoxville, Memphis, and Wichita.
Poor: Des Moines, Lincoln, Nashville, Norfolk, Omaha, St. Louis, and St. Charles.
Not rated: Little Rock.

Incidentally, isn't it time we stopped talking about new leadership in Nashville and started doing something about it?

As you well know, the results in your region were far from outstanding. However, the example set by Alexandria, Baltimore, Louisville, Washington I, and Washington II demonstrated that strong leadership and determination can overcome even the most adverse conditions. Please do everything possible to get your lagging branches to emulate them.

Mr. Hughes. You're saying to emulate Alexandria.

Mr. Ball. Yes, sir; to emulate the results in Alexandria, in both of the Washington offices.

Mr. Hughes. You were telling him, Mr. Ball, you were telling him, essentially, to aggressively overdraft, because that's what they were doing to earn those profits.

Mr. Ball. No, sir. There was certain——

Mr. Hughes. Mr. Ball. Mr. Ball, that's precisely what Alexandria was doing, is it not?

Mr. Ball. And it is not what Washington I was doing.

Mr. **Hughes**. I asked you about Alexandria, and you can answer the question.

Isn't that what Alexandria was doing?

Mr. **Ball**. I have subsequently learned that it was.

Mr. **Hughes**. And weren't you saying to Latshaw, "I want you to do what Alexandria is doing"?

Mr. **Ball**. No, sir. No, sir.

Mr. **Hughes**. You didn't say that?

Mr. **Ball**. I was not telling—I was not suggesting that he have the other offices aggressively——

Mr. **Hughes**. How can you explain what you mean by "do everything possible to get your lagging branches to emulate Alexandria"?

Mr. **Ball**. I was telling him, Mr. Chairman, to have the lagging branches emulate the branches whose performance was good.

Mr. **Hughes**. Including Alexandria. And Alexandria was overdrafting aggressively and earning literally tens of millions of dollars in concert with other branches that were illegal. And you're telling the branches to emulate that.

Isn't that what you're doing?

Mr. **Ball**. No, Mr. Chairman. A month later, in that memo that you brought out before, when, for the first time there was a breakout of the interest earned on drawdown by the Hutton branches, I did specifically—and it is the first time that drawdown profit had been broken out, to my knowledge, separately—I specifically asked a question—"seems overly aggressive, were the shots being called well?" And, again, that's just a month after this, so I think you can see that I was not aware of the excessive overdrafting. When I saw some figures that, for the first time, indicated there might be something that's improper, I did ask a question about it. I'm not pretending to be omniscient, but in that particular case I did.

Mr. **Hughes**. Well, I have another important memo that I want to ask you about, but we don't have time right now, so I'm going to recess for 10 minutes and come back.

[Recess.]

Mr. **Hughes**. The subcommittee will come to order.

I want to followup just a little bit on this memorandum of February 25, 1982, to John Latshaw before I get into this other memorandum.

The documents that we've had from the judgment of conviction that was entered show that each one of these offices that you've indicated as excellent was involved in overdrafting, aggressive overdrafting: Alexandria, Baltimore, Louisville, Washington I, and Washington II. I remember from the documents that we have and from the judgment of conviction that was entered, these, each one of these offices was involved.

Mr. **Ball**. Including Washington I?

Mr. **Hughes**. Including Washington I—was included in the judgment of conviction.

And my question to you—and I'm not sure I got an answer—was, what were you asking John Latshaw to do when you asked him to "do everything possible to get your lagging branches to emulate these offices"?

Mr. Ball. I was asking him to encourage and to lead the offices to have profits, bottom lines, that were as good as those offices which I had rated as having excellent results for that particular month, Mr. Chairman.

Mr. Hughes. Can you see where John Latshaw might get the impression you want them to duplicate what they were doing?

Mr. Ball. Yes, but not by having them excessively or illegally overdraft.

Mr. Hughes. But, in fact, that is what they were doing.

Mr. Ball. I was unaware of that. Mr. Latshaw, I believe, was unaware of that.

Mr. Hughes. So that you say that even though you did ask them to emulate, that that was unwitting on your part.

Mr. Ball. Yes, sir.

Mr. Hughes. Is that your testimony?

Mr. Ball. As I said before the recess, Mr. Chairman, the next month I did ask a question about the level of interest profit in two of those offices when that came out for the first time as being a pure "here is what the drawdown system is generating for two of those offices."

Mr. Hughes. And it never occurred to you that you should find out what they were doing to earn such interest profit?

Mr. Ball. No, sir, it did not. Again, there were many, many parts of profitability that weren't just interest profit, so there are a whole bunch of components, as you know.

Mr. Hughes. How could you fulfill your responsibility as the president of the company, whose job it was to maximize profits, and not know what generated profits in the company and what didn't?

Mr. Ball. I'm sorry, sir, I didn't hear you.

Mr. Hughes. What generated profits and what didn't? How could you possibly discharge your responsibilities as president to maximize profits when you didn't know what was generating profits? Because that is your testimony.

Mr. Ball. Our clear understanding was that the sales of various types of securities generated revenues, which generated profits. And I know you're not asking about that——

Mr. Hughes. No, no. You also knew that there was some overdrafting creating interest profits.

Mr. Ball. I knew that there was a drawdown system that involved overdrafting by my definition.

Mr. Hughes. Mr. Ball, why don't you just answer my question; we'll save a lot of time.

My question was: You also knew that there was some overdrafting going on and that was generating interest profits. That's not a very difficult question.

Mr. Ball. Yes, there was a drawdown system which was a part of the interest profit component.

Mr. Hughes. From overdrafting?

Mr. Ball. Yes.

Mr. Hughes. Now, that wasn't too painful.

As president of the company, you, in addition to approving the hiring or disapproving the hiring of a messenger, you, from time to time, made decisions on whether or not to send material parcel post, did you not?

Mr. BALL. Yes, I've seen a memorandum where I asked whether Federal Express or parcel post should be used.

Mr. HUGHES. Don't respond just because you have a memorandum that suggests that. My question is—we do have a memorandum that suggests that, but I'm saying to you, you did approve or disapprove sending material parcel post; isn't that so?

Mr. BALL. Just like any other manager, I would look at minutia from time to time to——

Mr. HUGHES. So, you were interested in trying to maximize profits, keep expenses down, and yet one area of the company during this 1981–82 time frame that was generating a tremendous amount of interest profits from overdrafting you knew nothing about.

Mr. BALL. I was aware that profits were a very major component of Hutton's income. I believed that that was largely derivative of the sales activities that brought funds through Hutton. I believed that to be correct.

Mr. HUGHES. As president of the company, did you have to report to the board of directors on the activities of the company?

Mr. BALL. No, sir; I did not in the sense that you are asking.

Mr. HUGHES. You did not report to the board of directors?

Mr. BALL. I was a member of the board of directors. Mr. Fomon conducted those meetings, and there was not a formal report by me or anyone else on a scheduled basis to the board.

Mr. HUGHES. I see.

I'm going to ask you to take a look at a memorandum which is dated February 9, 1982, from Michael P. Castellano to yourself. The subject is interest on regional bank overdrafting.

Without objection, I'm going to put this in the record.

[The information referred to follows:]

FEBRUARY 9, 1982.

To: George Ball.
From: Michael P. Castellano.
Subject: Interest on Regional Bank Overdrafting.

Although you have made the decision to give branches credit for interest earned via overdrafting of the Regional Bank Account, how these branch interest credits are determined and accounted for is still unresolved. The importance of this is underscored by the magnitude of these credits—$5,400,000 or 28% of the $19,700,000 regional interbranch costs in 1981. (see attached)

ACCOUNTING

I feel strongly that the interest should be allocated to branches as a credit in the interest category and not as an offset to regional interbranch charges. If the interest were accounted for as an offset to regional interbranch, incentives to control these rapidly growing costs would be reduced since, in a region with large regional overdraft interest credits, net regional costs would be cut in half.

In addition, the recently implemented regional interbranch system would be undermined. The main reason it was changed was to standardize the allocation method and types of costs passed on to branches. If regional overdraft interest was used to reduce regional interbranch, standardization would be lost to the extent this interest varies from region to region. Since the same P&L effect can be achieved by a credit to the net interest total by branch, I believe this is a more reasonable approach. In discussion with Jim Daniel, he agreed completely.

The attached schedule indicates the magnitude of the $5.4 million by region and leads to more questions (as does everything that we seem to touch these days). Some of the questions raised are:

1. If New York is drawing down 30 branches in the Atlantic Region and 6 branches in the Central Region directly, are we losing the extra float for the firm?

2. If the Mountain and South Central Regions are drawing down branches in other regions, how do we get the credit back to the proper branch (and region)?

3. Is the Southeast Region doing a poor job or are the credits being earned by the South Central Region?

4. This calculation was made by asking the regions which bank accounts they were using to overdraft the branches. If there were other accounts thent he $5.4 million would be somewhat higher.

I will review these questions with Tom Morley.

ALLOCATION

I can think of three ways to compute each branch's share of this interest credit:

1. Calculating each branch's relative percent of total net interest vs. all branches in the region.
2. Calculating each branch's relative percent of total general ledger interest for all branches in the region (the largest segment being bank account overdrafts).
3. Utilizing each branch's relative percent of regional interbranch allocation.

The second calculation seems to be the most equitable way of motivating branches with the best cash management since this interest line basically reflects interest earned from regional drawdowns of branch accounts. However, the first calculation, utilizing net interest would also be motivational and would stress better margin account cash management, free credits and short sales. Whichever we choose, a quarterly journal entry would be the most feasible way of handling the credit and it would be based on a year to date status.

I would appreciate your comments or if you would prefer to discuss it, please let me know. I will have to prepare a detailed memo instructing the Regional Vice Presidents and Regional Operations Managers' of the decision and methodology.

MICHAEL P. CASTELLANO.

E.F. HUTTON & CO., INC., 1981 REGIONAL INTERBRANCH ALLOCATION, DECEMBER 1981

	Direct exp	Indirect exp	E.B.C.	Sub-total exp	Unusual items	Net exp	Allocation	Surplus (dollars)	Deficit (percent)
Atlantic	223,994	2,413,340	503,005	3,140,339	171,000	2,969,339	3,004,600	35,261	1.2
Central	345,725	2,012,159	328,073	2,685,957	747,527	1,938,430	1,937,760	−670	−0
Midwest	218,908	2,213,137	327,373	2,759,418	55,100	2,704,318	2,706,558	2,240	.1
Mountain	241,734	1,205,772	192,268	1,639,774	23,500	1,616,274	1,618,340	2,066	.1
New England	36,430	1,075,558	217,665	1,329,653	0	1,329,653	1,328,251	−1,402	−.1
Pacific North	217,042	1,181,109	204,875	1,603,026	0	1,603,026	1,603,110	84	0
Pacific South	231,773	1,936,818	335,097	2,503,688	0	2,503,688	2,494,900	−8,788	−.4
South Central	17,742	1,332,029	223,654	1,573,425	13,500	1,559,925	1,565,920	5,995	.4
Southwest	90,578	368,001	4,363	462,942	119,423	343,519	343,735	216	.1
Southeast	341,865	2,595,451	263,318	3,200,634	84,634	3,116,000	3,122,475	6,475	.2
Totals	1,965,791	16,333,374	2,599,691	20,898,856	1,214,684	19,684,172	19,725,649	41,477	.2

Interest earned by overdrafting on regional bank accounts

A97	$180,000
A13	250,809
A98	[1] 239,287
C22	[2] 271,785
F02	50,373
F03	309,949
F97	842,978
H53	[3] 673,735
J30	96,753
J98	285,286
K & L53	764,194
N40	85,820
N46	144,731
N86	48,144

N87	35,432
N97	[3]957,346
P96	154,333
R53	[4]35,301
Total	5,426,256

[1] 30 offices are drawn down directly by N.Y.S.D.
[2] 6 offices are drawn down directly by N.Y.S.D.
[3] Draw down branches in other regions.
[4] Some offices drawn down by other regions or branches.

Mr. HUGHES. Had you seen that memoranda before from Mr. Castellano?

Mr. BALL. I have seen the typed memorandum previously, Mr. Chairman, yes.

Mr. HUGHES. What is the thrust of this memorandum? What does it purport to recall?

Mr. BALL. The memorandum relates to a compensation question which was brought to me by Mr. Castellano for a decision.

Mr. HUGHES. There was somewhat of a dispute, wasn't there?

Mr. BALL. Yes, sir.

Mr. HUGHES. As to who was going to get interest on overdrafting?

Mr. BALL. Yes, on the drawdown of the branch's bank account.

Mr. HUGHES. Well, that's overdrafting, isn't it?

Mr. BALL. In the sense that I'm using it, yes.

Mr. HUGHES. One of the things that is on here, and I presume you saw at the time, was, most of the way down, it raises some questions. In fact, there are four questions raised. One of them is: "If the mountain and south central regions are drawing down branches in other regions, how do we get the credit back to the proper branch and region?"

And then, alongside of it, is a "Y". Is that your writing?

Mr. BALL. No, sir.

Mr. HUGHES. It's not?

Mr. BALL. I've not seen the writing on this document.

Mr. HUGHES. What is that alluding to?

Mr. BALL. Straightforward, I would read it as saying if the mountain region and the south central regions are drawing down offices in other regions, how, in an accounting sense, does the credit for that drawdown get back to the proper branch, which is in a different region?

Mr. HUGHES. Aren't they saying, "Who's going to get credit for it, you know, what branch, how are we giong to whack it up?" Isn't that what it's saying?

Mr. BALL. Yes, sir.

Mr. HUGHES. And is that chaining?

Mr. BALL. No, sir.

Mr. HUGHES. What would be the reason for the mountain region and south central regions drawing down branches in other regions?

Mr. BALL. The regions in Hutton drew down the branches, and then New York drew down the regions, as you've had testimony and know.

Mr. HUGHES. Yes, but this is region to region.

Mr. BALL. Yes, sir, but the mountain region, for example, had branches that had been a part of it, and then, in restructuring of

Hutton, had been moved into other regions, and where the administrative work was still done in the mountain region.

Similarly, in the south central region, just to give you a quick and simple answer, the south central region was composed of the State of Texas, except for one office which was a Texas city that was part of another region, and I don't remember which one now, let's say El Paso or someplace out in the west side of Texas. That office, I believe, was administratively, and therefore, I would infer, drawdown-wise handled by the south central region.

Mr. HUGHES. So your testimony is that it had nothing to do with chaining, it had to do with some changes that were made in the structure of the company.

Mr. BALL. I believe it was pure administrative alignment of Hutton and nothing else, sir.

Mr. HUGHES. Finally, I want to ask you about the memorandum which I know you are aware of, from yourself to Bob Witt, which talks about March performance. It's dated April 30, 1981.

Do you have that before you?

Mr. BALL. Yes, sir; I do.

Mr. HUGHES. And the essence of this is a report from you to Bob Witt, which says, in essence, that his region "stood first in March * * * below are my perceptions of the performance of each of your offices for the month"—and you go through the excellent offices, the good offices, none that are fair or poor. And then you indicate: "The region had a superb month. How did Rick manage to generate a 48-percent profit margin? Was it largely legal interest profit?"

Mr. BALL. Yes, sir.

Mr. HUGHES. Now, I wonder if you can tell us, is that an accurate reflection of what you said in that memo?

Well, first, is that your signature on the memo?

Mr. BALL. I can't read the signature that's on the copy I have. I just, really and truly, can't see——

Mr. HUGHES. Have you seen it before?

Mr. BALL. I've seen the memorandum before.

Mr. HUGHES. Have you seen your signature on it before?

Mr. BALL. I'm told that it is not my signature.

Mr. HUGHES. You're told that it is not your signature.

Mr. BALL. Yes, sir.

Mr. HUGHES. Had you seen the memorandum before?

Mr. BALL. I had seen the memorandum before, yes.

Mr. HUGHES. What is it that was meant by "was it largely legal interest profit?"

Mr. BALL. Mr. Chairman, I do not recall at this point what I meant when I dictated the memo. I have very seriously been trying extremely hard to recall what prompted me to question the 48-percent profit margin in the office. That was the Portland, ME, office, by the way. Rick was the name of the manager of the Portland, ME, office. And I really do not remember 4 years after the fact what I said at that time.

Mr. HUGHES. Well, then, is it possible that that is an accurate reflection of what you said?

Mr. BALL. As the staff knows, and, I believe, as accounted to you, as my counsel has been searching through documents that were at

Hutton they were informed by my secretary that she had the stenographic pads on which there was the shorthand of what I had dictated when I wrote this note in 1981. My secretary gave and read the shorthand stenospeak or stenowrite or whatever it's called to the——

Mr. HUGHES. Well, let's talk about that. I'm going to put in the record the stenographic notes, without objection.

Mr. BALL. Please.

[The documents referred to follow:]

EF Hutton
INTER-OFFICE MEMORANDUM

TO Bob Witt

FROM George Ball

DATE April 30, 1981

SUBJECT March Performance

33 x 11 = 363

Your region stood first in March. Noted below are my perceptions of the performance of each of your offices for the month:

__Excellent__ 4

Burlington
Burlington — Executive Park
Glens Falls
7 Hartford
Manchester 28
Portland
Salem

__Good__ 3

Albany
Boston
4 Chestnut Hill
Providence 12

__Fair__

__Poor__

The region had a superb month. How did Rick manage to generate a 48% profit margin? Was it largely legal interest profit?

George Ball

GLB/jdv
cc: Paul Crabtree

NE

— R Ad a spt N. kw dd Rjcl rnz t gra a 48% pft rnyn? uz t lgl NB pft?

f Daly, A. Phelan

— Chicago rgnl cndl pa of ought t b dz blr o — blz ji. — per t pd auspicious, bt — fie f dz nt pen f t par

P.K.

wr of dd pgbl wl. Portland + Modesto wr pp rnpsr; z uz — Intnl o pflD —rD — R.

P.S.

— R Ad a nc blr N. Spdra + Frs Mkt ar pp OSz.

Analra o pflD t SB bra revivify Upvsl Cl.

fs. y dd P.S. admin zo lz red ink.

SC

— R Adi a ny pe N lo a fw o t Angllr Lt. l t i. hw dd Dallas & Beaumont rnz 50% pft rngr: gi a ft t i uzn a aclz anxiety

Mr. Hughes. I have the notes before me, and maybe you can, since you're talking about them—does that help refresh your recollection is—the "LGL" would stand for either "largely" or for "legal." She does not remember, she says, which of those two that it was.

Well, it would seem to me if it were "largely," you would have an "L" and a "Y" somewhere.

Mr. Ball. Mr. Chairman, I don't know. I am not an expert in this. I can only recount for you what my secretary told——

Mr. Hughes. But you have no independent recollection of this?

Mr. Ball. No, sir.

I do tend to think it more likely the "LGL" would stand for either "largely" or for "legal." She does not remember, she says, which of those two that it was.

Mr. Hughes. I don't blame you.

Mr. Ball [continuing]. Of the—But I think I can explain why.

Mr. Hughes. I don't blame you for wanting to recall that.

Mr. Ball. Can I explain the why?

I do not blame you for that, either, but I think there is some rationale behind it sir, if—

Can I go on on that for just a minute?

Mr. Hughes. Sure.

Mr. Ball. I believe that I was dictating from a run which I believe the committee has seen, that shows the profit, just the bottom line of the offices. Had I seen the profit for the Portland office segmented into operating profit, interest profit and total profit, I would not have questioned the interest income. The interest income in that month which I've just been shown in the last week or so was 10 percent of the revenue. The operating profits were 39 percent. And it would have been somewhat inane to question the legality or the size of an interest profit that was just about average on the nose for all of E.F. Hutton's branches at that point in time.

Mr. Hughes. But that is supposition on your part at this time.

Mr. Ball. It definitely is supposition. I do not remember which I dictated. If I said "legal," I obviously was asking Mr. Witt, who is the regional vice president supervising the Portland branch, to find out, "Hey, why isn't the interest profit—what's it composed of or why is it so big?" The interest profit was not large. The operating profit was quite large, causing the total profit margin to be very large, but I would have had no reason to question had I seen the interest profit, the composition.

Mr. Hughes. Well, Mr. Ball, I don't have any other questions. I think we've exhausted the subject.

I must say, in all candor, I find some of your testimony incredible in some areas. I find it incredible that E.F. Hutton could operate a scheme involving 2,000 criminal counts of mail and wire fraud involving literally tens of millions of dollars, with a zero balance or special account of a billion dollars to cover overdrafts, involving as many as 113 branch offices if the Justice Department judgment of conviction is accurate, and I'm not sure that it's totally accurate, involving most of the regions, which had a drawdown system that involved individuals from every level, including headquarters level, and nobody knew what happened: Nobody is responsible, nobody carried it out. The branches point to your shop and other shops. You folks point to the fact that it must have been the branches off the reservation. But the fact of the matter is it had to be participated in at every level of the corporate structure.

So, with that, the subcommittee stands adjourned.

We appreciate your testimony and you are excused.

The subcommittee is adjourned.

[Whereupon, at 1:49 p.m., the subcommittee was adjourned.]

E.F. HUTTON MAIL AND WIRE FRAUD CASE

FRIDAY, DECEMBER 6, 1985

House of Representatives,
Subcommittee on Crime,
Committee on the Judiciary,
Washington, DC.

The subcommittee met, pursuant to call, at 10:22 a.m., in room 2141, Rayburn House Office Building, Hon. William J. Hughes (chairman of the subcommittee) presiding.

Present: Representatives Hughes, Mazzoli, Smith, Staggers, McCollum, Lungren, Shaw, and Gekas.

Staff present: Hayden Gregory, counsel; Virginia Sloan, assistant counsel; Charlene Vanlier Heydinger, associate counsel; Fred Stuckwisch, GAO consultant; Theresa Bourgeois, staff assistant; Phyllis Henderson, clerk; and Brenda Lang, staff aide.

Mr. **Hughes**. The Subcommittee on Crime will come to order.

Good morning. I want to apologize for the delay but, as you know, we have a vote still in progress and I imagine other members will join us very shortly.

Today marks the beginning of the final stage of this subcommittee's hearings on the Justice Department's handling of the *E.F. Hutton* case. In the past several months, we have heard testimony from a number of officers and employees at Hutton itself, as well as from Hutton's outside auditors and consultants on cash management. These past hearings were essential to a full understanding of what were the illegal activities in which Hutton engaged, and what was the information the Justice Department had before it when it decided to dispose of the case through a plea bargain.

As I have stated in the past, this subcommittee's jurisdiction is twofold: We are concerned not only with the atmosphere in corporate boardrooms that encourages white collar crime, or at least permits it to occur, but also with the Department of Justice's decisions on whether and how to prosecute these kinds of cases.

We have read about a number of white collar crime cases where the company has been allowed to plead to reduced charges; has received what is perceived by many as a lenient sentence, and/or no individuals have been prosecuted. We want to know whether this is the result of a particular philosophy of the Justice Department, or whether the facts of each case warranted such a disposition.

Once the Hutton investigation is complete, we intend to move on to examine some of these other cases and develop a more complete picture of the Department's handling of white collar crime cases.

As in any oversight investigation, the cooperation of the agency under examination is essential. Without that cooperation, we cannot fully examine the record and reach fair and accurate conclusions.

Next Wednesday, we will hear testimony from officials of the Department here in Washington, who came into the case several months before Hutton pleaded guilty, and who set overall policy both for the disposition of the case and for cooperation with this subcommittee's investigation.

Two weeks ago, we unfortunately had to subpoena the Department to obtain the records we believe are essential to our investigation; the department's failure to comply with our subpoena will be the first item on our agenda next week.

Today, however, we are anxious to hear from the two people who probably know most about *United States* against *E.F. Hutton:* Assistant U.S. Attorney Albert Murray; and Postal In[illegible]ctor John Holland. Mr. Murray developed this case from day [illegible] and Mr. Holland from almost that time. From everything we [illegible] learned about it, that was a monumental task. If not for their [illegible]orts, I believe there would not have been a case at all.

I want to say, before I recognize the Ranking Republican for such preliminary observations as he would like to make, that it is my belief, after some 6 months' involvement in the case, that the case was very ably investigated by Mr. Holland. And I want to extend the congratulations of the Chair for a very able job; and to Al Murray, who did an extremely good job in developing this case, preparing it for almost 2 years before Justice in Washington became more directly involved in the case.

The Chair at this time recognizes the gentleman from Florida.

Mr. McCollum. Thank you, Mr. Chairman.

I would like to especially welcome our witnesses. Mr. Albert Murray, Jr., you referred to. He has done a yeoman's job as Assistant U.S. Attorney in Scranton, Pennsylvania for the last several years, not just on this case but on many other cases. In fact, Al Murray is the only individual to have received the Chief Inspector Certificate of Appreciation from the U.S. Postal Inspector Service on two occasions. It was first presented to Al in 1982 for prosecution of 30 politicians for political fraud.

I don't know about that one, Mr. Chairman.

Mr. Murray. Glad to be here, Mr. Chairman.

Mr. McCollum. Al received the Chief Inspector Certificate for Appreciation again this year for his work on the E.F. Hutton investigation.

I am delighted to have the opportunity, Al, to discuss the investigation that you initiated in 1982 and continued through this year.

As Al so aptly told the Institutional Investor, Hutton was doing 170 in a 55-mile-per-hour zone, while everybody else was only doing 75. This unique perspective will be very valuable to the subcommittee investigation.

Al, I welcome you.

I also understand that our second witness today was also indispensable—as the Chairman referred to—to this investigation. Mr. John Holland from the U.S. Postal Service, from the Inspector's Office, gave his continuous, non-stop, laborious commitment to the effort all along, with the help of many other Postal Inspectors who I know were associated with this.

Mr. Chairman, as I understand, there was no smoking gun in this case. These two gentlemen and their assistants felt the case from nothing but years of hard work—2½ years, to be exact. Without their efforts, the extent of the fraud would not have been discovered, and hundreds of banks with the funds of millions of Americans would still be exposed today.

Gentlemen, I welcome you. Your story should be told, and I am very, very pleased to hear it today.

Mr. Chairman, the Institutional Investor did quite a story on Al Murray and this investigation in its September issue. One of the articles from that magazine has already been put into the record. And, with your permission, I would like to enter the story on Al Murray into the record.

Mr. HUGHES. Without objection, so ordered.

[The article follows:]

[From the Institutional Investor, September 1985]

THE MAN WHO NAILED HUTTON

(By Barbara Donnelly)

"What kind of stupidity would cause someone to write $8 million worth of float off little Genesee Country Bank?" asked Muriel Siebert, former New York State Banking Commission chairman and now head of her own Wall Street firm, somewhat incredulously. "Imagine a local bank clerk faced with a check that size. They just don't see that every day!"

Indeed not. When one of E.F. Hutton & Co.'s New York branch offices tried to withdraw $8 million from the firm's account at the small upstate New York bank on Friday December 11, 1981, the bank's auditor, John Lounsbury, became worried. He made a quick check of Hutton's account and turned up another suspicious item: a newly deposited $8 million check drawn on United Penn Bank in Wilkes-Barre, Pennsylvania.

For the sake of prudence, Lounsbury called United Penn to see if it had sufficient good funds on hand from Hutton to pay down that check. He found that, on the contrary, Hutton's United Penn account was backed by yet another uncollected check drawn on another Hutton account in New York City. The two banks investigated further, and, discovering a pattern of deposit churing by the brokerage firm, they bounced both $8 million checks and notified New York State banking authorities and the Federal Deposit Insurance Corp.

That event, like split-second mistiming in a sharper's shell game, fatally exposed the deceit behind the cash management practices of the nation's fifth-largest brokerage firm. Before long, bank examiners would discover a billion-dollar pattern of shifting and elusive overdrafts to which some of the nation's largest banks were massively exposed. Soon thereafter, an unknown assistant U.S. attorney from the hills of Pennsylvania would take up the case and become convinced that what most people called aggressive cash management was instead a set of illegal practices that threatened not only the safety of the banks but the entire U.S. economy. He would begin an obstinate three-year pursuit of a complex paper trail that ended last May 2 with a guilt plea by E.F. Hutton to the most sensational white-collar crime of the decade. And in ways that Genesee Country Bank's Lounsbury never envisioned on that chilly Friday four years ago, legal lines would be drawn that would irrevocably change the future course of corporate cash management.

MYSTERIOUS TRANSFERS

The Hutton saga really got under way in early 1982, when the Genesee-United Penn complaint was still shuffling across the federal investigators' desks in both New York and Pennsylvania. New York bank regulators and Federal Reserve Bank of New York officials took the investigative lead, and before long the Genessee paper trail led them to two big New York institutions, Manufacturers Hanover Trust Co. and Chemical Bank, where Hutton maintained central cash management accounts. An Audit of four days of Hutton's activity at those two banks exposed huge, mysterious funds transfers back and forth between them. At Manny Hanny, in particular, examiners uncovered a range of drawdown activity that left the bank exposed overnight to Hutton overdrafts of up to $1.3 billion—well in excess of its legal lending limit.

"We were really concerned about the safety and soundness of the banks," recalls Siebert, who presided over the investigation. "It wasn't the $8 million checks at the Genesees that bothered us; it was the really large amounts shuttling between the big banks."

The auditors found three practices that account for overdrafts. First, the firm was check crossing—overdrafting its accounts at two money center banked simultaneously and depositing each of the overdrafted checks in the other bank. Second, Hutton was writing huge continuous overdrafts on its special segregated accounts, which were backed not by the firms's money but by customers' margin money from commodity transactions. The third, and perhaps the most difficult overdraft practice to trace, was tied into what happened at the Genesee bank—a continual cycle of huge overdrafts created by checks written on Hutton's New York accounts and deposited in local banks across the country, which in turn were the target of more rounds of Hutton check writing, and so no. "We knew we had something more," recalls Siebert, but the New York regulators' jurisdiction didn't allow them to follow the Hutton paper trail outside New York State.

The magnitude of the discovered overdrafts came as a complete surprise to Manufacturers Hanover, insiders say. And though Manufacturers chairman John McGillicuddy assured regulators that he was satisfied with his bank's "global relationship" with Hutton, Manufacturers did soon take action. The bank imposed such tough new restrictions on Hutton that the firm moved most of its cash management business elsewhere. Manufacturers refused to comment, but Hutton officials confide that the firm soft-pedaled these aspects of the case partly because of fears that bad publicity would affect Manufacturers' standing. (The bank seems appreciative; in a recent letter written to Hutton chairman Robert Fomon, McGillicuddy expresses goodwill and gallantly declines, unlike others, to seek, restitution from Hutton for the overdrafts.)

Although Chemical chairman Donald Platten had insisted, like McGillicuddy, that he was happy with his bank's relationship with Hutton, Chemical's new head of Wall Street brokerage business, Stephen Laserson, had put the screws on Hutton throughout 1981 to curb overdrafting and restore the profitability of its accounts. He forced Hutton to leave excess funds on deposit interest-free at Chemical to make up for $440,000 of interest due on overdrafts. But such problems were all in the family, the banks argued.

After regulators met with Hutton's lawyers in February 1982, the firm initiated an in-house probe that showed that certain widespread cash management practices didn't square with company policy. So Hutton shut the whole system down pending an overhaul. It hired Arthur Young & Co.'s cash management specialists to complete the task, all the while urging them to hurry up, since sticking with "plain-vanilla" practices was causing excessive deposits to accumulate to its backs' benefit.

In light of such remedial measures by Hutton and the assurances of its banks, the New York regulators were satisfied all was under control. They thought about alerting federal investigators to their findings but, because of the legal vacuum surrounding the practice, couldn't decide whether Hutton had infringed upon the law. They had already concluded that Hutton could not be charged with check kiting, since it had the means and avowed intent to eventually pay its obligations; by merely making off with interest profits while its checks cleared, they reasoned, Hutton was pursuing aggressive cash management, nothing more. "If a bank isn't making money on a customer relationship, that's a business decision—it's none of our business" says one banking commission member. "Our role concerns safety and soundness; otherwise, we'd literally be running these institutions."

ATTORNEY'S DEMAND

In May 1982 the New York State Banking Department and the New York Fed had completed their final joint report and were still debating what, if anything, to do. That decision was taken out of their hands when Albert Murray, a young assistant U.S. attorney from the middle district of Pennsylvania, showed up to demand a copy of the report.

Murray's interest in the case had first been aroused in April, when a friend, Harrisburg-based postal inspector Richard McGee, called Murray's Scranton office to alert him to a memo about the United Penn complaint that had been sent by the FDIC to the offices of U.S. attorneys and postal inspectors in New York and Pennsylvania. Murray was intrigued—especially since the memo involved a household name like E.F. Hutton—and started sniffing around. He got word of the New York regulators' report from FDIC auditor Joseph Modla, and that seemed as good a place as any to start.

At first the New York banking regulators refused to hand over the report—partly because they felt the turf of federal law enforcers didn't extend to banking problems. So Murray, following his gut feeling that there was more to the Hutton case than met the eye, simply subpoenaed the study on the spot. He admits that at the time he lacked even the most rudimentary grasp of cash management—"I thought $8 million was a lot of money and that overdrafting was illegal. Boy, was I naive!" But he was motivated, at least during the initial stages, by his awe of the sheer magnitude of the nations cash-moving business, which turns over $170 trillion in one year. "I was prompted largely by intellectual curiosity about how such huge sums—billions of dollars a day—moved through these systems," he recalls.

With the New York report in hand, Murray worked over the next eight months to gather other documents—bank audits, Fed audits, New York State audits and Hutton's own records. He also checked with U.S. attorneys' offices across the country to see if other banks had complained about the firm's practices, but he turned up nothing. Hutton, meanwhile, left the matter in the hands of New York law firm Cahill Gordon & Reindel, which it had retained when the New York examiners first called.

In turning its attention to Murray, a relatively unknown quantity, Cahill Gordon tried two angles of attack. "First, they called me all the time," says Murray. The attorneys wanted to bring voluntary witnesses and selected evidence to help him—unschooled as he was about cash management—understand the salient facts of the case. But Murray demurred. "I didn't want them to stipulate the facts to me, because I wasn't ready for them and they could have snowed me." After a while, Murray became suspicious of the lawyers' insistence that everything could be explained face to face. "It seemed to me that they were protesting too much," he recalls. Where persuasion failed, Cahill Gordon buried the assistant U.S. attorney in paper—7 million documents' worth of it, which had to be transported to Pennsylvania from Hutton's Manhattan headquarters in two 40-foot trailer trucks.

In the meantime, Murray was forced to deal with other cases, and months later all but a few key documents still lay moldering in an unused office in the Scranton federal building. By mid-1983, however, Murray's work load had lightened up, and he began to turn his attention back to Hutton. It wasn't an inviting task. "That was one point where I almost let the whole thing drop," recalls Murray, "but I thought it would be intellectually dishonest to do so before I'd made an effort to see what was in the rest of those documents."

ENORMOUS OVERDRAFTS

In the months that followed, Murray, with the go-ahead of his boss, U.S. attorney David Queen, and support from a 25-member task force of postal inspectors from Harrisburg and across the country, began pursuing the tangled paper trail of Hutton's cash management. Using complex computer systems, they set to work ferreting out from the sea of audit figures regular patterns of overdrafts at Hutton's banks.

Gradually, Murray's initial intellectual curiosity was superseded by another motivating force. As he now puts it: "I was bothered by a moral sense that some of the movements of cash in the system made no gut sense. It's one thing being competitive in the use of your cash, but it's quite another to make money out of an inefficiency in the system." As Murray saw it, "If you earn a dollar, you're entitled to a dollar, not a penny more. Nobody makes money for free. So if you're making money from a system, even if it's to recapture float that naturally occurs, someone loses—the Fed or the bank ultimately pays."

In Murray's evolving view, there was something very wrong with a system that exposed banks overnight to billions of dollars of overdrafts. The son of a Brooklyn criminal court judge, Murray grew up in Bedford-Stuyvesant, one of New York's toughest neighborhoods. He sees the law's role—and, by inference, his own—as not only prosecuting the guilty but as safeguarding the nation's financial system as well. Thus, for him, the Hutton investigation started to take on much broader, even idealistic, parameters. He began to view cash management, as he now puts it, as "an elitist, esoteric area that needed to be examined, expecially since it exposed the banks and economy to risk. We really believed we were working for the good of the economy, for the protection of the banks—whether they recognized it or not."

Murray's sense of fairness was also disturbed by Hutton's explanation for the consistently negative balances that his investigators turned up in its bank accounts. The firm insisted that the overdrafts were simply the result of a basic, perfectly legitimate cash management technique called "target balancing" that works this way:

A company deliberately overdrafts its accounts using a preset "drawdown" formula in order to keep the balance at a minimum "target" level and thereby avoid overcompensating its bank for services. What bothered Murray, however, was that Hutton was setting those targets unilaterally, without its banks' knowledge. And having discovered, through the bank audits, that other companies were doing precisely the same thing—albeit perhaps not on such a grand scale as Hutton—he recalls: "I started questioning the validity of industry practice. I took the view that the use of a drawdown formula and the theory of recapturing float, which were supported even by the experts, were in and of themselves fraud."

By early 1984 Murray felt ready, through the Hutton case, to pursue, in his words, "a reexamination of the whole corporate euphemism of aggressive cash management." He convinced his boss, Queen, that he had enough evidence to start calling witnesses for the grand jury investigation, which had begun in April 1982 and in February 1984 was moved from Scranton to Harrisburg in order to help forestall leaks to the media. Even though the patterns of Hutton's overdrafts were still random and somewhat confusing, Murray and the investigative team felt sure that they had enough evidence to convince a grand jury that Hutton's confusing, aggressive use of target balancing was not an acceptable buisness technique but a scheme to defraud its banks, which were unaware of the practice.

DASHED HOPES

The investigator's high spirits were quickly dashed, however, when the testimony of their very first witness ran circles around their theory. Among other things, the witness undermined the crux of their argument—that Hutton had misrepresented what it was doing to its banks—by asking: How could the banks *not* 1 have known, when there was proof they had asked Hutton to reimburse them for the cost of the firm's overdrafts and had been satisfied? The prosecutors hadn't prepared well enough for the "this is business between two knowing parties" argument, which had stumped the New York regulators two years before.

With that fiasco, dissent and doubt grew among the investigators, and Murray again began to wonder whether he should drop the case. He realized that when it came to understanding the politics of bank-customer relationships and the complex ambiguities of float-playing games, he was still a real naif. To bring both themselves and the jury up to speed on the nation's clearing system, the investigators postponed calling further Hutton witnesses and called in banking experts and cash management experts instead. Meanwhile, Murray instructed every member of the investigating term to bone up on banding and float by reading, among other sources, the "Fed Funnies"—comic-BOOK-style primers on the banking and check-clearing system published by the Federal Reserve.

As the grand jury investigation proceeded, Murray became increasingly frustrated by his inability to find a definitive authority on what constituted "standard" cash management practies. No book no banker, no auditor, no consultant, no regulator would clearly establish that Hutton's target-balancing practices represented fraud. Indeed, many banks victimized by Hutton's huge overdrafts insisted that the firm had merely been "aggressive." "This was not something that was a clear-cut crime." recalls Murray, pointing out that at the time there were no legal standards governing the use of float. "We questioned ourselves about whether or not we had a case time and time again. We had to develop a theory of prosecution and *sell* it to the Justice Department."

Gradually, however, as Murry and his team began to understand the finer subtleties of float, that theory began to emerge. When pressed hard under oath. Hutton's banks admitted that Hutton had indeed lied to them about how their accounts were being used—that some of their practices seemed to cross a vague and heretofore undefined line between legitimate target-balancing techniques to "recapture" float and flagrant schemes to "create" float artificially at the expense of the banks or the Federal Reserve. As Murray now puts it, the view began to evolve on his and the investigators part that "it is okay to benefit from a loophole in the system, but you cannot seek to widen it, to *intentionally* tear the fabric that much more."

To demonstrate the legal line, or tear point, between legitimate and fraudulent float games, Murray's team decided to focus in on two "aberrations" in Hutton's cash management system, which it felt were clear evedence that Hutton was intentionally misleading its banks on how it used that system.

TWO "ABERRATIONS"

The first "aberration" was the pattern of "excessive and arbitrary overdrafts," which bore no relation to either customer receipts or the amounts dictated by Hutton's drawdown formula. The firm covered these overdrafts a day later by checks drawn on disbursement accounts designed not for that purpose but for paying bills—thus providing the proof Murray needed that Hutton was intentionally misleading its banks about how it was using the collection side of its cash management system (see diagram, page 70). By constantly staying one step ahead of its banks and earning interest on the artificially inflated paper balances, Hutton was practicing what Murray calls the "Wimpian school of cash management." Paraphrasing the famous line of the Popeye character, he jokes, "Hutton paid you Tuesday for the use of funds today."

The second "aberration" was the technique called "chaining," which had been dicovered as part of the Genesee Country Bank complaint investigated by New York's banking regulators. Instead of passing the day's branch receipts in a straight line up through the firm's concentration network—from local bank to regional bank to money center account—Hutton sent checks scurrying through local banks scattered all over the country, often channeling funds through as many as fifteen institutions before they reached the money center banks. Each time a check hit a new bank in the chain, it would be pooled with the receipts from the town's branch and a much larger check would be written—thus vastly inflating the dollar volume of checks Hutton had circulating at any one moment and increasing the firm's odds of earning higher amounts of interest on the float resulting from any breakdown in the Fed's check-clearing system.

The crazy-quilt patterns of Hutton's check chain—many of the branches were located in remote or blizzard-prone locations—were clear proof to Murray that the firm was intentionally misleading its banks. It was using its concentration system not, as it claimed, to most efficiently gather up its branch receipts but, as in the case of the excessive overdrafts, to artificially *create* float that it could profit from at its banks' or the Fed's expense.

By now, Murray and his investigators, bolstered by their better understanding of cash management, were aggressively pushing their view that Hutton's entire cash management system was, in Murray's words, "inherently flawed." It design and the incentive system that drove it—Hutton branch managers earned a 10 percent cut of te profit earned on overdrafts—both lent themseleves to a broad range of abuses. But the federal investigators still lacked one dramatically clear-cut piece of evidence to demonstrate how Hutton was intentionally, and consistently, aiming to defraud its banks.

That breakthrough came in early 1984, when Mary Ann Munley, the lead accountant on the investigative team, uncovered evidence that turned the fortunes of the feds. In the sleepy town of Williamsport, Pennsylvania, little Northern Central Bank was found to have been unwittingly providing, day in and day out, $900,000 of interest-free funds to Hutton for the last few months of 1981. There was no pattern of random overdrafts here: the uniform columns of negative balances starkly illustrated how local Hutton branch employees had consistently disregarded the firm's drawdown formula and had simply drawn down the account by the same arbitrary amount day by day. "This produced the clearest example of what the whole philosophy of the system was designed to do—create float," says Murray. It was evidence and jury could grasp.

TWISTS OF FATE

Then, two twists of fate intervened to bolster Murray's case even further. In November of last year, Hutton chairman Fomon brought the case up over lunch at Washington's exclusive Jockey Club with then—Attorney General William French Smith and his wife. That faux pas prompted an angry phone call to Fomon from Justice Department criminal chief Stephen Trott—who was merely monitoring the case at that point—warning that such private contacts were clearly verboten. Ironically, the meeting, confided one investigator, "give our case a lot of credibility with the department." Then, in January of this year, Murray's boss, U.S. attorney Queen, moved over to the Treasury Department, and Justice stepped in to assume direct authority for the case—a move that gave the case even greater credibility, which would not in all likelihood have happened had Queen's departure not left a void of responsibility for the investigation.

Anxious weeks followed nevertheless, as Hutton's lawyers flew back and forth to Washington in a last-ditch attempt to convince the Justice Department to drop the case. Then in late January the word came down: The Department of Justice was prepared to indict Hutton on criminal charges for scheming to defraud its banks. But in order to make its case as airtight as possible and ensure it would hold up all the way to the Supreme Court if necessary, Justice chose to focus its criminal charges narrowly on the two aberrations—excessive overdrafts and chaining—which clearly showed misrepresentation and therefore a scheme to defraud. For Murray, who had hoped to go after target balancing and a whole range of Hutton's cash management practices in the case, this was something of a disappointment. "I wanted to attack the system itself, not just the aberrations," he says. "However, they thought it was too difficult to prove."

Nevertheless, prosecutor Murray was yet to see his wishes fulfilled. In a final ironic twist, Hutton chose instead to plea bargain, waiving its right to trial and admitting guilt to criminal charges of fraud. It feared that a long jury trial would expose the firm to years of nasty publicity and keep its brokerage license hanging in jeopardy. Thomas Curnin, a Cahill Gordon lawayer, had "met with the board, and what he said scared the daylights out of them, so they caved," say a well-placed Hutton insider. And during the plea bargaining, in exchange for, amoung other things, the Justice Department's agreement not to name individuals in its indictment and to omit specific references to other cash management abuses, such as tampering with the microencoding on its checks. Hutton agreed to what in Murray's estimation was a "tremendous coup" for the prosecution: Attached to the criminal charges against Hutton was a precedent-setting civil injunction that, for the first time, drew legal lines for the entire industry around target balancing and a broad range of cash management practices (see previous story). Say Murray: "All the things Hutton was doing were not a clear-cut crime. But they pleaded guilty, and by doing so, Hutton set the legal standard."

Had the Hutton case gone to trail, the Justice Department was prepared to name at least a half-dozen Hutton executives. The fact that they gave up this bargaining chip in the plea agreement has exposed them to acid criticism from both the media and Congress, which, in its current investigation into which Hutton top managers knew about the fraud; is doing what many critics feel should have been Justice's job. But Murray insists that nailing individuals would have been "extremely difficult, if not impossible," simply because Hutton's cash management practices weren't clearly illegal until its precedent-setting guilty plea. Moreover, Hutton employees not only did not believe they were committing a crime, but many had also been granted immunity during the grand jury investigation. In addition, says Murray, "It was extremely difficult to prove people at headquarters knew about this, because branch and regional people had a lot discretion about how to run the operation."

ACTUAL RELIEF

In plea bargaining away the right to indict individuals, Murray may have opened himself and the Justice Department up to criticism, but he also avoided a trial. And, indeed, he gives the impression that he is actually relieved that the case did not end up before a jury. He points out that because of the close relationships between Hutton branch managers and their banks, Justice knew that "the banking witnesses were reluctant to cooperate with the prosecution." Justice also feared a possible acquittal, simply becasue the judge and jury might be confused by the issue. And the department was also concerned about scapegoating—that "a few people would be blamed for practices that were the product of a companywide philosophy."

But more important as far as Murray is concerned, had Hutton gone to trial on two narrow abuses of its system, there would never have been that precedent-setting civil injunction that defines legal standards for the entire cash management industry—which, as he points out, had been *his* primary goal from the start. Concludes Murray, with no small amount of satisfaction: "A plea agreement is truly a compromise where neither party gets everything they want. In our case, however. I believe the government got everything it should have gotten and maybe even a little bit *more*." As a result, it's safe to say that cash managment will never be the same again.

Mr. McCollum. Thank you.

Mr. Hughes. Our panel consists, as I indicated, of Albert Murray, assistant U.S. attorney, Middle District of Pennsylvania in Scranton. He served in that particular post for the last 6 years. He is a member of the New York and Pennsylvania Bar Associations and former district attorney and public defender of Monroe County, PA. Mr. Murray has tried over 250 civil and criminal trials over the last few years during his career.

As my colleague from Florida has indicated, he is a recipient of numerous awards, including the National Postal Inspector's Award.

We welcome you today, Mr. Murray.

Mr. **Murray**. Thank you very much.

Mr. **Hughes**. And John Holland is the postal inspector in Harrisburg, PA, in the area of fraud. His assignment for the past 10 years has been in that capacity. He has been a postal inspector, as I understand, for some 14 years.

Mr. **Holland**. That is correct.

Mr. **Hughes**. He is the father of three daughters and a graduate of Northeastern University in Boston, MA. He has a Bachelor of Arts degree in business and is an Army veteran.

We welcome you.

Mr. **Holland**. Thank you, Mr. Chairman.

Mr. **Hughes**. We have at the table this morning Stephen Trott, with the Justice Department, here in Washington.

Mr. **Trott**. Thank you, Mr. Chairman.

Mr. **Hughes**. Pursuant to clause 1 of rule XI—sorry, rule XI, clause 1 of Rule X of the Rules of the House of Representatives—this hearing of the Subcommittee on Crime of the Committee on the Judiciary is an oversight investigation of the E.F. Hutton mail and wire fraud case. Let the record indicate that pursuant to clause 2 of rule XI of the Rules of the House of Representatives, copies of the Rules of the Committee on the Judiciary, and clause 2 of rule XI, in particular, of the Rules of the House of Representatives have been made available to witnesses, and are available at the witness table.

Mr. Murray, Mr. Holland, you have a right to counsel to assist you in the course of this morning's proceedings.

Are you accompanied by counsel?

Mr. **Murray**. On behalf of myself, no. And I do not request counsel.

Mr. **Holland**. Mr. Chairman, I am not represented by counsel and do not request counsel.

Mr. **Hughes**. OK.

Mr. Murray and Mr. Holland, I will place you under oath now. Would you stand at this time and raise your right hand?

Mr. Murray, Mr. Holland, do you solemnly swear or affirm that the testimony you are about to give to this committee is the truth, the whole truth, and nothing but the truth, so help you God?

Mr. **Holland**. I do.

Mr. **Murray**. I do.

Mr. **Hughes**. Please be seated.

That had to be a different experience for you.

Mr. **Murray**. That is right. Usually I am putting somebody else under oath.

Mr. **Hughes**. All right.

Mr. **Murray**. That is wonderful.

Mr. **Hughes**. Why don't we proceed with your testimony, Mr. Murray, first, and I will operate today under the 5-minute rule. We are going to strictly comply with the 5-minute rule. That means that Members of Congress will have 5 minutes in which to ask questions. And after we get through all the testimony, I would ask the witnesses to respond to the questions. Be brief, because lengthy answers eat into the 5 minutes of the Members.

We do have a lot of material to go over today. We will, during the proceedings this morning, get to the point where you will be able to expand upon the nature and extent of the scheme at E.F. Hutton and other matters that, in fact, are pertinent to the case.

I am going to begin the questioning this morning, Mr. Murray, by asking you when you first learned of the allegations against Hutton?

TESTIMONY OF ALBERT MURRAY, ASSISTANT U.S. ATTORNEY, MIDDLE DISTRICT OF PENNSYLVANIA, SCRANTON; AND JOHN HOLLAND, U.S. POSTAL INSPECTOR, HARRISBURG, PA

Mr. **Murray**. With all due respect, I had assumed that I would be able to, Mr. Chairman, make a brief statement, as an opening statement, and that my written statement would be the statement submitted by the department, which I was a part of preparing. And then I was told that I would be able to expand a little bit on the statement that the department has made, which I have adopted, and also the information in the Institutional Investor article. That is what I was told I will be able to do.

Mr. **Hughes**. The Justice Department will be testifying next week, and I know there is a statement that was submitted to a previous hearing which next week will be made a part of the record at the time Mr. Trott testifies. That was my intent, that that would be the time for that statement to be introduced into the record.

If you have a brief oral statement you would like to make, I would recognize you at this time.

Mr. **Murray**. Oh, thank you very much.

Also, I am usually accustomed to standing. Would that be all right to do that?

Mr. **Hughes**. Sure.

Mr. **Murray**. It will make me feel a little more comfortable.

Mr. **Hughes**. Just like summing up to the jury. Go right ahead.

Mr. **Murray**. Just looking for the truth as the jury does, also.

One, I want to thank the committee for giving me this opportunity to be able to appear before you. I have been waiting for approximately 7 months to be able to try to put in perspective a very complex situation. I hope that today I will be able to explain a very complex situation which affects the country. And I appreciate the opportunity to be able to do that and to bring before the public and the country exactly what this situation was all about.

I am proud to say that I had very nice discussions with and dealings with counsel for the committee and the investigative team. Everything was very nice and cordial between us.

If I might just state from the beginning, that basically John Holland and I, and a team of Postal Inspectors, for 2 years, like, we worked in anonymity in Harrisburg, PA. And in March 1984, what we did is we joined forces and hands with the Department of Justice basically to try to fight two wrong situations and two—what we believed were two evils, for one purpose. The two evils we were fighting were practices that we believed to be fraudulent, also.

One was, we were fighting E.F. Hutton; and the second, what we were fighting was the cash management system in this country which very few people know about.

The main purpose of what we were trying to do for all those almost 3 years, especially the last 2 years, was to do it for the country, to do it for the people of the country. It may sound like I am flag waving, but we spent that time and our efforts to do just that—to try to benefit—to expose certain practices that we thought threatened the financial health of the country.

We believed that basically there was a double-standard that existed in the country between how the banking industry deals with corporate America and how the banking industry deals with the individual.

What we did is, we found that there was a system that did not monitor the actual financial systems that were moving trillions of dollars in this country, and which affects all of us. Every single time we sit down and write a check, we are concerned about floating, what happens to that check, and that whole process. Yet, there is a completely different standard for corporate business America.

As John and I and Peter Clark and Bob Ogren and Steve Trott—as we developed this case—and we did it together; and if anybody says other than together, we did it together—as we developed the case, we slowly began to unravel a system which we saw like a cancer and that we had to cut that cancer out swiftly before the entire body would die.

The one thing we eventually saw in all those 3 years—and I will explain in detail between—I will stay here all night long, come in tomorrow, I will go to your home, I will explain all day how this scheme works.

Mr. HUGHES. That won't be necessary.

Mr. MURRAY. OK.

What we saw is, there were novel and new issues involving financial cash management that nobody really knew about. We found the law was basically nebulous and undefined. We found that the guidelines in cash management were nebulous at best, and that basically these presents were being euphemistically referred to as aggressive cash management practices; and that it really was no scheme until May 2, 1985 when we established that.

I have been watching for seven months and sitting back and watching and listening to the media and everybody say that this was a felonious felony. I think that is probably what the purpose of this is.

I think the Chairman is very interested in making sure that Justice was done in this case.

I just want to say a couple things: that ultimately E.F. Hutton is a very viable entity. E.F. Hutton, in a way, has a soul. It has a soul just like America has a soul. And that when America collectively is attacked, it threatens the very way in which we live in this democracy.

Hutton itself is an entity. It has an identity and may be identified with an individual that wears a three-piece suit—and I have one on, too—but a three-piece suit and a certain way of thinking and talking. But Hutton is a very—they are a corporation that has an identity.

When that corporation—by pleading guilty to even one felony and places its lifeblood on the line—it jeopardizes not one person but 17,000 persons. Just like America is threatened, the country is threatened, and it jeopardizes all of us.

Specifically, on the individual issue—and I will go into that with more detail—John Holland and the Postal Inspectors, some of which are here—we don't play favorites. Steve Trott didn't play favorites. Peter Clark didn't play any favorites for these big, high corporate muckity-mucks. We didn't favor anybody. If anybody had tried to make an attempt to influence me or Steve or anybody, we would have walked out and would have been right to this committee and the press. It just didn't happen. It just didn't happen.

Hopefully, I will be able to explain what I know about this situation. It just didn't happen. It was good, hard, tough prosecution.

Some people say, well, you didn't charge any individuals and you didn't—you just didn't do it, so therefore inherently something in my gut feels bad about that. I would say this: that I don't indict—I would not propose an indictment much less try to convict a person because he is a president of a company or because he is a chairman of the board or because the public thinks it ought to happen.

What my standards have always been as a prosecutor—has always been to prosecute someone that I believe I could prove a case beyond a reasonable doubt and I could get a conviction based upon that person's actual guilt. I do not take that duty lightly; and that if, in fact, that was the case, we would have done—that would have been done.

But one of the important things, I believe, I didn't want to roll the dice with the banking system or the Federal Reserve and commercial banks in this country which—I hate to do figures—but which moves $10.1 trillion annually across this country, and $60 billion daily. I was not trying to roll the dice with that.

Sometimes what happens is that a prosecutor has to bite the bullet. I have to worry about not losing my objectivity in being subjective in the fight, in the fray, over the long two years with Hutton and all their attorneys and everyone. I had to watch out that I didn't get into a direct ego conflict with the officers of the Hutton Company, but that I looked at it objectively and cooly to be fair. That is what I considered to be justice.

Sometimes I had to bite the bullet and look back on my own ego and say, no, this is what the proof is that I have. There is no analogy, and I hope I can explain, but I hope I really can show you today that there is no analogy you can make between the bank robbery and a person who threatens a bank with a gun and what E.F. Hutton did in conjunction, in some cases, with the bank, with the approval of many of the banks. I hope I can prove that to you.

What we did is we tried to set guidelines, policies. We tried to set a speed limit for the first time ever in the type of situation that existed here.

There is no individual—I know in my heart—there is no individual of E.F. Hutton walking around saying, "I got away with a crime." It just doesn't exist.

On the contrary, what is happening is these individuals, most of them, as well as E.F. Hutton, in most instances, is saying, "What did I do wrong?" It is incredible that part of corporate America still doesn't understand the scheme and what was done wrong, and that these practices were fraudulent.

Sometimes what happens is that you have a system where no individuals themselves may be believing they are committing a crime, and it will not act willfully and intentionally, but that the collective intent of the whole form the basis of the criminal prosecution for the corporation, the collective intent of the whole.

Based upon what? Based upon whether or not those persons believed that the industry practice was, in fact, valid, an industry practice that we have set.

What we were trying to do—and I appreciate the time—what we were trying to do is take a chaotic situation, which I think I will be able to explain to you today, and bring order to that chaos, hoping that—this is my—this is just my hope—hoping that Congress would take the flag and run with the ball from there, because I am not a legislator—I am a prosecutor—maybe they are right; a little idealistic—but I was hoping that we would start a trend that would protect the public of this country and that Congress would start to look at these practices and start to legislate to equalize the double-standard and unfairness in the banking system as it affects you and I as we sit down and write a check every single day.

That is what I wanted to do. I wanted to rectify a problem and hope that Congress would do what it should do, which is reform then the banking system. That is my honest-to-God feeling. That is what I prayed for for 3 years.

I thank you for the time. And the only thing I can say is that I appreciate you listening to me. It has been built up for 3 or 3½ years, and I will sit here today all day long as long as you want. I will explain how the Hutton system worked. I will explain to you the chains, the excessive drawdowns. I will explain the evolution of the cash management system that was not totally understood by lawyers, that was not totally comprehended by the accountants in this country, and that was not clearly understood by the bankers.

I had a very—John, I, Peter, Steve and Bob had a very unique opportunity in this grand jury investigation to be sort of ombudsmen to see how the banking system works, a very esoteric and elite system that practically before I started this case I had no knowledge about; I could barely balance my own checkbook.

But, anyway, we had a very unique opportunity, and I hope that I will be able to tell you exactly why we did, and made the prosecutor's decision to take a plea agreement that brought overwhelming benefits to extricate the cancer.

So thank you.

Mr. HUGHES. Well, thank you very much, Mr. Murray.

Let me just assure you that we do appreciate your professionalism, and I have not heard anybody question your integrity.

Mr. MURRAY. Well, OK.

Mr. HUGHES. Which has been beyond dispute. I appreciate the 2 hours that you and I have had to talk about philosophy in this case, and I want to tell you that I personally have a great deal of regard for you, and I think you handled the case ably, as I indicated.

I don't think that that is in dispute. We may disagree about certain decisionmaking, but as I indicated to Mr. Trott at the inception of the case, I know how important it is for prosecutors to be able to make some decisions about whether to try a case or not to try a case.

And unfortunately, a case of this nature is wrapped up in the public interest, and much of the information that came out about this case was most unfortunate.

Mr. MURRAY. I agree.

Mr. HUGHES. You must have been appalled at some of the press releases coming out of E.F. Hutton.

Mr. MURRAY. Yes, I was.

Mr. HUGHES. After the plea was accepted?

Mr. MURRAY. Yes.

Mr. HUGHES. One would not understand the nature and extent of what they pleaded to if one were to take some of the press accounts.

Mr. MURRAY. That is correct.

Mr. HUGHES. And I appreciate your candor in that regard.

Mr. MURRAY. You are also invited to my house in Marshall's Creek. I have high regard for you.

Mr. HUGHES. When did you first learn of the allegations against Hutton?

Mr. MURRAY. With all due respect to 6(e) also, I have to be very cautious not to violate that rule, because I would be held in contempt, so what I will be trying to do in my testimony is not to violate rule 6(e).

Mr. HUGHES. We have documents that would indicate, that were furnished to us by Justice, as to when you were first contacted.

Mr. MURRAY. In response to your question, I first learned about this activity in May 1982 as a result of a postal inspector, Dick McGee, coming to my office saying, "Al, the bank is complaining about E.F. Hutton."

Mr. HUGHES. When were you first assigned to the case?

Mr. MURRAY. I believe I was assigned to the case after I had a meeting with Dave Queen, almost immediately, and basically, my attitude was I would look into the allegations.

So, it was practically within the same week.

Mr. HUGHES. When was the grand jury first convened?

Mr. MURRAY. Well, the grand jury subpoena really commences the opening of the grand jury, so our first grand jury subpoenas were issued, I believe, in May—May 10, 1982.

Mr. HUGHES. The grand jury was not specifically convened for Hutton. It was already a sitting grand jury in the Middle District of Pennsylvania, and the first grand jury, I believe, subpoenas were returnable to Harrisburg, PA.

And I presume that you basically were in control of the case at that time, handling the case?

Mr. MURRAY. I was in control of the case from day one until right now.

Mr. HUGHES. When did you first contact Hutton's lawyers?

Mr. MURRAY. Oh boy, specifically the date, I am not familiar with. Shortly after service of the subpoena, I believe, on May 10 or May 11.

Hutton's lawyers contacted me regarding the fact that we had received Robert Fomon. We had received the offers of the corporation. We were requesting numerous, numerous documents from them. So, it was practically the same day of the subpoena.

Mr. HUGHES. Am I correct in assuming that any negotiations with the attorneys for production of documents was done by yourself?

Mr. MURRAY. Yes, that is correct.

Mr. HUGHES. Eventually, Mr. Murray, you began negotiating with Hutton's lawyers about more things than just production of documents.

Mr. MURRAY. That is correct.

Mr. HUGHES. When did that take place?

Mr. MURRAY. The first—as I recall, the first serious negotiations regarding this case came approximately 2 years later in April 1984, as I recall.

Mr. HUGHES. April 1984.

Mr. MURRAY. Yes, 1984. Two years later.

Mr. HUGHES. OK.

Mr. MURRAY. I did not negotiate at all with the attorneys for the first 2 years. I refused to meet with them.

Mr. HUGHES. I see. Now, during this period of time certain individuals were identified as target defendants, were they not?

Mr. MURRAY. Well, the first individual—the first individuals were targeted in around April 20, 1984 I believe. The basis for that was—so that you understand my thinking in targeting—does not mean they would, in fact, be indicted.

Mr. HUGHES. I understand.

Mr. MURRAY. I just want—my purpose was to put them on notice that, in fact, they may have some exposure to criminal charges and to allow them to then provide exculpatory evidence they believe proved they were not, in fact, involved in any activity.

So, as a result of that, I—in every case I do, I have face witnesses, I have subjects, and I have targets.

Mr. HUGHES. At that time, were target communications sent out to those individuals?

Mr. MURRAY. Yes, they were.

Mr. HUGHES. Did they retain counsel?

Mr. MURRAY. Yes, they did.

Mr. HUGHES. Each of them had counsel?

Mr. MURRAY. Yes, they did.

Mr. HUGHES. Was it separate counsel?

Mr. MURRAY. Yes, they did at that time. At some subsequent time I sent additional target letters to different individuals, and some of those individuals, as I recall, had joint counsel, especially regarding the E.F. Hutton corporation itself.

Mr. HUGHES. In April 1984, who were sent target letters? What individuals?

Mr. MURRAY. I am really not at liberty to respond to that. I am not sure that I can or not under 6(e).

I know that the committee has the submissions of the—I think we turned them over.

Mr. HUGHES. We have, yes.

Mr. MURRAY. OK.

Mr. HUGHES. Identify them for the record for us.

Mr. MURRAY. I believe that Michael Costellano was sent a target letter. I believe Bill Sullivan, the former money mobilizer, was sent a letter. I believe that Norman Epstein was—he was later sent a target letter. I believe that Arthur Jensen was sent a target letter at that time. That is what I recall.

Mr. HUGHES. Do you have a memorandum that was prepared at that time which recited the targets?

Mr. MURRAY. I believe I did. I don't know—that memorandum was prepared November 1984, not in April.

Mr. HUGHES. As of June 19, 1984, from memorandums turned over to us by the Justice Department target letters, Ball, Lynch, Ray, Epstein, Miller——

Mr. MURRAY. No, no, no. That is not true. Mr. Ball never received a target letter. Mr. Miller never received one, I don't believe. He may have, but Mr. Ball never received a target letter.

Mr. HUGHES. I see.

Mr. Holland, can you be of assistance? Do you remember target letters for Messrs. Ball, Lynch, Ray, Epstein, Miller, Castellano, Morley, Sullivan, Jensen, and Anderson?

Mr. HOLLAND. Excuse me, Mr. Chairman, but I don't recommend who is to be targeted in an investigation in my function as an investigator.

Mr. MURRAY. Mr. Chairman, I do that. John Holland does not recommend, and Arthur Anderson was not included as a target.

What I did was prepare a memo in November 1984 which listed possible subjects and possible targets, possible co-conspirators, etc., etc., etc., that, in the event that evidence was so developed, that they may, in fact, be putative defendants.

Mr. HUGHES. Let's do it this way. I offer for the record copies of the target letters. Is there objection? Hearing none, so ordered.

[The target letters follow:]

(TARGET LETTERS)

13-1

U.S. Department of Justice

United States Attorney
Middle District of Pennsylvania

Room 435 - Post Office Building
Washington & Linden Streets
Scranton, Pennsylvania 18501

717/[illegible]
FTS/[illegible]

April 20, 1984

E.F. Hutton Group, Inc.

Dear Sirs:

This is to advise you that you are a target of a Federal Grand Jury investigation being conducted in the Middle District of Pennylvania into possible violations of federal law including 18 U.S.C. 2, 18 U.S.C. 371, 18 U.S.C. 1004, 18 U.S.C. 1341, 18 U.S.C. 1343, 18 U.S.C. 1961 et. seq., among others.

You are being officially advised of this matter in order to afford you an opportunity to request to testify and to bring to the attention of this office any information, witness identities, documents, or like material which may bear in any way on your innocence or non-involvement in the above investigation. If you have any such information, it should be made known to this office within ten (10) days so that it can be carefully considered and a determination made as to whether it would be appropriate to present it to the Grand Jury prior to the termination of this particular investigation.

You are hereby advised that any decision by you to request to testify and/or to recommend other evidence to be considered by the Grand Jury must be completely voluntary and that any such testimony or evidence could be used against you if any criminal charges should be returned against you.

If you have any questions regarding this matter, please have your attorney contact this office immediately.

Very truly yours,

DAVID DART QUEEN
United States Attorney

By: ______________________
ALBERT R. MURRAY, JR.
Assistant U.S. Attorney

BEST COPY AVAILABLE

13-2

U.S. Department of Justice

United States Attorney
Middle District of Pennsylvania

Room 426 - Post Office Building
Washington & Linden Streets
Scranton, Pennsylvania 18501

717/961-2924
FTS/592-8301

April 20, 1984

E.F. Hutton and Company, Inc.

Dear Sirs:

This is to advise you that you are a target of a Federal Grand Jury investigation being conducted in the Middle District of Pennylvania into possible violations of federal law including 18 U.S.C. 2, 18 U.S.C. 371, 18 U.S.C. 1004, 18 U.S.C. 1341, 18 U.S.C. 1343, 18 U.S.C. 1961 et. seq., among others.

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Very truly yours,

DAVID DART QUEEN
United States Attorney

By: ______________________
ALBERT R. MURRAY, JR.
Assistant U.S. Attorney

13-3

U.S. Department of Justice

United States Attorney
Middle District of Pennsylvania

Room 428 - Post Office Building
Washington & Linden Streets
Scranton, Pennsylvania 18501

717/961-2924
FTS/592-8391

April 20, 1984

Mr. Norman M. Epstein

Dear Mr. Epstein:

This is to advise you that you are a target of a Federal Grand Jury investigation being conducted in the Middle District of Pennsylvania into possible violations of federal law including 18 U.S.C. 2, 18 U.S.C. 371, 18 U.S.C. 1004, 18 U.S.C. 1341, 18 U.S.C. 1343, 18 U.S.C. 1961 et. seq., among others.

Certification of checks

RICO

You are being officially advised of this matter in order to afford you an opportunity to request to testify and to bring to the attention of this office any information, witness identities, documents, or like material which may bear in any way on your innocence or non-involvement in the above investigation. If you have any such information, it should be made known to this office within ten (10) days so that it can be carefully considered and a determination made as to whether it would be appropriate to present it to the Grand Jury prior to the termination of this particular investigation.

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Very truly yours,

DAVID DART QUEEN
United States Attorney

By: ______________________
ALBERT R. MURRAY, JR.
Assistant U.S. Attorney

13-4

U.S. Department of Justice

United States Attorney
Middle District of Pennsylvania

Room 426 - Post Office Building
Washington & Linden Streets
Scranton, Pennsylvania 18501

717/961-2936
FTS/592-8301

April 20, 1984

Mr. Thomas P. Lynch

Dear Mr. Lynch:

This is to advise you that you are a target of a Federal Grand Jury investigation being conducted in the Middle District of Pennylvania into possible violations of federal law including 18 U.S.C. 2, 18 U.S.C. 371, 18 U.S.C. 1004, 18 U.S.C. 1341, 18 U.S.C. 1343, 18 U.S.C. 1961 et. seq., among others.

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If you have any questions regarding this matter, please have your attorney contact this office immediately.

Very truly yours,

DAVID DART QUEEN
United States Attorney

By: ______________________
ALBERT R. MURRAY, JR.
Assistant U.S. Attorney

13-5

United States Attorney
Middle District of Pennsylvania

Federal Building, 228 Walnut Street
Post Office Box [illegible]
Harrisburg, Pennsylvania 17108

717/782-4482
FTS/590-4482

April 20, 1984

Mr. Arthur Jensen

Dear Mr. Jensen:

This is to advise you that you are a target of a Federal Grand Jury investigation being conducted in the Middle District of Pennylvania into possible violations of federal law including 18 U.S.C. §§2, 371, 1004, 1341, 1343, 1961, et seq. among others.

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If you have any questions regarding this matter, please have your attorney contact this office immediately.

Very truly yours,

DAVID DART QUEEN
United States Attorney

By: Albert R. Murray Jr.
ALBERT R. MURRAY, JR.
Assistant U.S. Attorney
per [illegible]

Letter given to: Parent Label
Scanning.
Verified that letter
by atty
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Lawrence Bader 7/1/84

13-

U.S. Department of Justice

United States Attorney
Middle District of Pennsylvania

Room 425 - Post Office Building
Washington & Linden Streets
Scranton, Pennsylvania 18501

717/961-2924
FTS/592-8301

April 20, 1984

Mr. Michael P. Castellano

Dear Mr. Castellano:

This is to advise you that you are a target of a Federal Grand Jury investigation being conducted in the Middle District of Pennylvania into possible violations of federal law including 18 U.S.C. 2, 18 U.S.C. 371, 18 U.S.C. 1004, 18 U.S.C. 1341, 18 U.S.C. 1343, 18 U.S.C. 1961 et. seq., among others.

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Very truly yours,

DAVID DART QUEEN
United States Attorney

By:
ALBERT R. MURRAY, JR.
Assistant U.S. Attorney

U.S. Department of Justice

United States Attorney
Middle District of Pennsylvania

Room 425 - Post Office Building
Washington & Linden Streets
Scranton, Pennsylvania 18501

717/961-2924
FTS/592-8301

April 20, 1984

Mr. Thomas P. Morley

Dear Mr. Morley:

This is to advise you that you are a target of a Federal Grand Jury investigation being conducted in the Middle District of Pennylvania into possible violations of federal law including 16 U.S.C. 2, 18 U.S.C. 371, 18 U.S.C. 1004, 18 U.S.C. 1341, 18 U.S.C. 1343, 18 U.S.C. 1961 et. seq., among others.

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If you have any questions regarding this matter, please have your attorney contact this office immediately.

Very truly yours,

DAVID DART QUEEN
United States Attorney

y: Albert R. Murray
ALBERT R. MURRAY, JR.
Assistant U.S. Attorney

13-8

U.S. Department of Justice

United States Attorney
Middle District of Pennsylvania

Room 425 - Post Office Building
Washington & Linden Streets
Scranton, Pennsylvania 18501

717/961-2924
FTS/592-8301

Hand Delivered to Attny. 4/25/84

April 20, 1984

Mr. William T. Sullivan, Jr.

Dear Mr. Sullivan:

This is to advise you that you are a target of a Federal Grand Jury investigation being conducted in the Middle District of Pennylvania into possible violations of federal law including 18 U.S.C. 2, 18 U.S.C. 371, 18 U.S.C. 1004, 18 U.S.C. 1341, 18 U.S.C. 1343, 18 U.S.C. 1961 et. seq., among others.

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If you have any questions regarding this matter, please have your attorney contact this office immediately.

Very truly yours,

DAVID DART QUEEN
United States Attorney

By: ALBERT R. MURRAY, JR.
Assistant U.S. Attorney

INTERVIEW WITH DAVID DART QUEEN

Mr. Queen was interviewed on November 1 and 5, 1985. He was the U.S. for the Middle District of Pennsylvania from March 1982 through December 1984.

Background: He first heard of the Hutton case when the first subpoenas were issued in May 1982. Someone had contacted AUSA Al Murray, and Queen assigned the case to him. Before the subpoenas were served, Queen was aware that this might be a major case.

Notification of DOJ: The DOJ guidelines require that the Attorney General be advised of any case meeting certain criteria, such as if the targets are Members of Congress, or if the case will generate substantial publicity. Queen did not advise DOJ until March of 1984 because he did not need DOJ's help, and he was not yet sure that the criteria were satisfied and that there was more to the case besides an incredibly complex set of facts.

Queen does not recall when they notified DOJ of the case (it was February or March 1984), but at some point he and Murray went to Washington to brief Lowell Jensen, Steve Trott, Fraud Section Chief Robert Ogren, Deputy Assistant AG Vickie Toensing, and Fraud Section lawyer Peter Clark. He does not know whether Attorney General Smith knew about the case at the time. It was logical that Jensen would advise him at some point, but he does not know when that occurred. The AG would ordinarily be notified if there was a reason for him to contact another Cabinet officer, if the AG might be publicly caught off guard, or if a high level policy decision needed to be made. At this point in the Hutton case, none of these reasons applied.

He is not sure whether he or DOJ initiated the meeting. No decision was made at that time about how to deal with public disclosure. The investigation was to remain secret.

DOJ's role in the prosecution: In June 1984, the Murray and Queen met with DOJ officials in Washington for the first time. At that meeting, or shortly thereafter, it was agreed that Ogren and Clark would aid in the grand jury phase. They would go to Pennsylvania periodically so that DOJ could understand the case better. Ogren's field role was "nominal."

After the June meeting, Ogren designated Clark to represent DOJ's Fraud Section in Pennsylvania. He is not sure whether this was a consensus decision, but "at least there were no wild protests." The reason was that this was a tricky, sophisticated case. Clark participated in the grand jury and, Queen assumes, the plea bargaining. Queen was not involved in the plea bargaining except to the extent that he refused Hutton's requests not to indict the case.

Queen would have been hard pressed to say that they didn't need help on the case, but he wanted to maintain the integrity of the issue and ensure that it remained a Pennsylvania case. Washington sees itself as the center of the universe, so Queen declared that decisions about the operation of the case would continue to be made by him. There was no dispute about this.

He left before the final disposition of the case, but saw Hutton as no different from hundreds of other cases. When a U.S. Attorney leaves, there is a power vacuum, which was naturally filled by DOJ in the Hutton case.

Venue: Venue was discussed at the June meeting. In particular, they discussed whether venue lay more appropriately in New York. Finally, they concluded that any U.S. Attorney's office had venue. In Queen's opinion, wherever the case was venued, Murray would have been transferred to continue the prosecution. No one advocated a change in venue, though.

Grand jury: Queen thinks live testimony began before February 1984. Initially, the grand jury was used only to accumulate documents.

The indictment: Fairly early on in the case, he and Murray agreed that, given the complexity of the case and the number of violations, Murray should begin assembling an indictment. They realized that they could always delete things later. They agreed that it was crucial to identify the basic violations, but that since RICO and conspiracy charges were easier to bring, they would decide about them later. Since RICO cases are hard to prosecute, as is conspiracy in the 3rd Circuit, he preferred not to charge them. He does not recall the Foreign Corrupt Practices Act being discussed seriously. He is not sure whether it was applicable. In the 3rd Circuit, mail and wire fraud cases are easier to prosecute, since the government need not prove a benefit to the defendant or a loss to the victim (in reality, this is the case in all circuits, since the statute so provides). Murray at first advocated using a bad check scheme, but U.S. v. Williams undercuts this charge in federal court. Queen was not so concerned about this charge since they had 2 or 3 other possibilities. He was concerned, however, that Hutton's conduct was in a legal "grey area." Thus there was an advantage to a guilty plea rather than to trial. He did not participate in the discussions about a trial versus a guilty plea, and is "no great legal scholar" but he felt comfortable taking the case to trial.

They did not have a definite target date for indictment, but they were up against the expiration of the grand jury in November 1984. He tried to avoid renewal of grand juries whenever possible. It is an enormous strain on the jurors to sit for 4 days a week for 18 months. The first grand jury, which did not hear live testimony, had already expired, and they had had to

"6(e)" the material to the second one. They did not want to empanel a third grand jury, so their choice was either to finish by November or to extend its term. Courts do not like to extend grand jury terms, and in case the motion for an extension was refused, they drafted an indictment. The judge did not, however, give them a hard time.

He knew the indictment would be approximately 700 counts, which violated the district's rules that an indictment may not exceed 20 counts without the chief judge's permission. In late spring or early summer of 1984, they computerized the basic charges and the postal inspectors began filling in the facts for each count. They operated on the assumption that they could not charge every activity; thus, they focussed on the "sexy" charges, on individuals, and on major transactions. A "draft" indictment was prepared, and close to the November expiration date, they had a "fairly cleaned up" draft. They could have presented it to the grand jury with relatively negligible effort. This would, however, have precluded pre-indictment negotiations and further investigation of the case, since the government cannot continue to use a grand jury to investigate an indicted case.

Queen had mixed feelings about the motion to extend. Part of him said "enough's enough." But another part worried that they could never go back, once the case was indicted. He supported the extension to ensure maximum thoroughness of the investigation.

Discussions about the extension began approximately 1 month before the expiration date. DOJ was a party to these discussions. Queen and Trott talked about it, and Murray had endless conversations with Ogren, the agents, and Queen, about it.

In a sense, it was a self-fulfilling prophecy that the grand jury was extended, because DOJ finally agreed to hear from Hutton's lawyers, but not until they had prepared extensive briefings, which could not be done by the November expiration date.

The decision to extend was not made by just one person. Queen told Murray that they did not have much choice, though Murray was "not wild about the idea" of extending. Queen signed the motion, and does not know why Clark was involved [we have a Clark memo stating that he will be going to Pennsylvania to move for extension]. Clark's presence in Pennsylvania at that point was "unpredictable."

Although there were several target dates for indictment, target dates always shift.

The New York State Banking Department report and other documentary and testimonial evidence led Queen and Jensen to be concerned that Hutton might be financially vulnerable, and that its activities might threaten its own and the banks' existence. Jensen was concerned that an indictment might cause panic in the financial community; thus, they should seal the indictment and get the approval of the judge supervising the grand jury to disclose the indictment to the SEC, which would stop trading in Hutton. Then DOJ would announce the indictment.

Civil versus criminal: He does not think this issue was discussed at the first meeting with DOJ. Hutton contended that the case should be disposed of civilly, but neither Murray nor Queen ever seriously considered it.

Statutory versus letter immunity: Queen had to approve all formal statutory immunity grants. Assistant AG Steve Trott would then have to approve the grant. Most immunity grants in Hutton were by letter. This was not to circumvent the statute, and was only used for lower level employees. Only Queen needed to approve letter immunity grants. Unless statutory immunity is granted, the government cannot compel a witness' testimony. Queen believes that there were some statutory immunity grants in Hutton, but cannot recall for whom or how many.

For statutory immunity to be granted, the individual must provide inculpatory testimony and the information must not be otherwise available.

Prosecution of individuals: This was discussed at the June 1984 meeting with DOJ. The question was asked how such a complex situation could have happened "by accident."

There was a lot of discussion in meetings with DOJ about whether to prosecute George Ball, but he was "marginal from day one." Ball was never told this, however. They never considered indicting Robert Fomon. Tom Lynch "had exposure, as did Tom Rae and Norman Epstein. In all, 4 or 5 high ranking officials "had exposure."

Many target letters were sent out, but this did not mean these people would be indicted. It simply meant that there was a reasonable, good faith belief that tended to show that the target might be implicated in a crime. Target letters were sent out if the government was going to interview or subpoena someone.

Many Hutton employees negotiated non-prosecution agreements. They received immunity in exchange for their cooperation. He insisted on an offer of proof, which was always oral because the employees' lawyers would not agree to written proffers. The majority of employees who testified got immunity because they refused to talk otherwise. He thinks it was foolish for them to demand immunity when they declared their innocence; in fact, many of these employees did not implicate themselves when they testified.

The granting of immunity maximizes the amount of information the government can obtain, and minimizes the number of targets. It is possible to immunize a case out of existence.

He is not sure how many people were immunized, but believes it was not an "enormous" number. For example, low level clerical types in the field were immunized, as were secretaries who filled out the drawdown sheets every day, but had no idea what the sheets meant.

From almost the beginning of the case, Queen decided against prosecuting branch level employees. They needed them to get to the higher level officials.

The question of indicting individuals was still open when Queen resigned his position.

Since a corporation does not have a 5th amendment privilege, it cannot be immunized.

Corporate liability: Corporations are easier to prosecute than individuals. A corporation is responsible for the acts of its employees, and can be liable even if its employees all act independently and even if they have no criminal intent, so long as their collective intent creates a crime. It was clear, then, that Hutton was going to be indicted. Hutton kept insisting that its acts did not constitute a crime, that they were accepted business practices, or at the most, "aggressive money management."

Transfer of supervision from Pennsylvania to Washington: Queen left on January 15, 1985. His temporary successor could not take over supervision of the Hutton case, but Queen made it clearly known that he did not want the case to become a DOJ case. This was for both "ego" and practical reasons, since 90% of the work had been done by Queen's office, the local grand jury, and the agents. The practical problem, however, was that there was a power vacuum when he left. Murray had no statutory authority to sign an indictment. He is sure that, had he stayed on, DOJ would not have taken over supervision.

DOJ never voiced any doubts about Murray's ability to handle the case. They were simply concerned about whether Pennsylvania needed more resources.

Perjury prosecutions: No one who was immunized "cooperated enthusiastically." They had no discussions, however, about solid perjury cases. Their instinct was that some witnesses were not being totally candid, but they had no time to make an example of anyone, and did not want to be diverted from the main issues. It would not make sense to wait until the case was indicted to prosecute for perjury, since then the coercive power of the perjury prosecution would be lost against other employees, and if they indicted during the investigation, the defense lawyers would gain access to grand jury materials.

Attorney conflicts: He and Murray were concerned that all of the Hutton lawyers met and "closed ranks." A couple of lawyers insisted that they would not talk about substance because they were concerned that their clients would be used. Queen thinks that the lawyers conveyed information among themselves and to their clients.

He learned that there were agreements for Hutton to pay the employees' counsel fees, and raised questions about whether this made the employees beholden to Hutton. They had many "go-rounds" with Hutton on this issue, but the law does not make it easy to "break a joint counsel conspiracy." He therefore did not want to waste resources on this issue.

Some of the lawyers had a vested interest in seeing Hutton cleared because Hutton's actions were based on their legal advice. This was also the case with Hutton's accountants.

Plea bargaining: In the summer of 1984, Hutton realized that "the jig was up." They could no longer wish the case away, so they tried to talk to Queen and DOJ about it, to forstall any charges. Queen refused to consider not prosecuting the company, and DOJ also refused. Hutton was also concerned about individuals being charged.

Relations with Hutton: Queen preferred that his assistants deal with counsel at the beginning of cases so that he could "remain above the fray." Hutton was upset that he would not meet with them but he felt he did not yet have enough information. Finally he met with George Ball's lawyer, Robert Fiske. Then he met with all of the lawyers on the case, all of whom said they wanted to discuss the case with DOJ. Trott decided to hear them out, saying that the worst that could happen is the government would discover Hutton's defenses. Trott also said that, all things being equal, a deal was better than a trial.

Since the meetings were more than just pro forma, DOJ required the lawyers to prepare extensive briefings. In a sense, then, it was a self-fulfilling prophecy that the grand jury would be extended.

Release of grand jury materials: They might have had to show grand jury testimony to the witnesses. Employees, as company agents, bind the company, so it is acceptable to show employee grand jury testimony to the company lawyers; this does not violate Rule 6(e). This may be necessary to make the defendant "face reality." He cannot, however, recall a specific instance where they showed grand jury testimony to Hutton. [We have a letter from Murray to Hutton lawyer Tom Curnin confirming that the government gave Curnin copies of grand jury testimony, among other things prohibited by 6(e)].

Mr. **Hughes**. Take a look at these target letters and see if they are accurate.

Mr. **Murray**. Sure. Thank you—if I could see them.

We prepared these, but they were not sent out. Some of these were not sent out.

Mr. **Hughes**. Identify for us, please, the ones that were sent out.

Mr. **Murray**. OK.

Mr. **Hughes**. And the ones that were not sent out.

Mr. **Murray**. They were all prepared on April 20, 1984. I prepared them in anticipation that, as evidence would develop, to send them out accordingly when I made the decision that the person would be targeted, and therefore they would be able to provide exculpatory information.

For instance, E.F. Hutton & Co., I believe, I notified Tom Curnin of the Hutton Co. and group, and he represented Norm Epstein.

That was sent out, not in April, but it was sent out toward the end of the investigation.

Arthur Jensen was sent out, I believe, in April. So was Michael Castellano sent out in April. Mr. Morley was, I believe, sent out in April. Mr. Sullivan was sent out in April.

The others were held. What you received from the department from my files were the prepared letters but not sent out.

What I do is I always prepare documents way in advance of the evidence so that I don't have to go back over and prepare them.

Mr. **Hughes**. Were others sent out subsequently?

Mr. **Murray**. No, I don't think any others, for George Ball didn't get a target letter.

Mr. **Hughes**. The Chair recognizes the gentleman from Florida.

Mr. **McCollum**. Thank you, Mr. Chairman.

I am going to jump around a little bit. This testimony today, I am sure you will find the questioning will move all over the board.

As much as we like to make it orderly, it just isn't going to be with so many different people questioning.

I would like to go to the bottom line in order that we might have that as a predicate to work backward from.

Mr. **Murray**. Sure.

Mr. **McCollum**. It seems to me the key question this committee is asking and has been asking throughout these proceedings is why you do not indict or prosecute the individual in the end—why the plea agreement was reached and the nature of it.

I will not expect you to, in the 5 minutes I have, to tell all the details that led up to this. You may have to describe the money laundering operations and all that. I would like to know, first of all, if you made the decision or if you didn't, who made the decision, not to go forward with an attempt to indict and bring charges against individuals?

Mr. **Murray**. I did. I made the decision. I made the recommendations to Bob Ogren and Steve Trott that I felt it was in the best interest of the country to accept the plea agreement and as we negotiated that over the past 3 years.

Mr. **McCollum**. Were you, in any way, pressured into making that decision, or——

Mr. **Murray**. Let me just——

Mr. **McCollum**. Or was it totally on your own?

Mr. MURRAY [continuing]. Let me just tell you something. Nobody pressures me, tells me what to do, tries to influence me or cause me to give up my morals, ethics, or principles.

The only person is God above and my dad right back there. He is the only person back there who tells me what to do.

I would like this clear, you know. The subcommittee won't, nobody in the department will. My loyalty is to the people of this country. I know that sounds corny. I know it does, but that is where my loyalty is.

I took that oath. I took that oath 6 years ago. You may say I am a do-gooder. If you want to put it that way, OK, so that nobody, nobody tells me what to do.

If I had thought there was anybody influencing this case after I put my life and job—and Peter and Bob—I know as a fact that we would have all resigned.

I know I would have. You would have seen me a lot earlier. It is just no way. I am just going to tell you.

Mr. MCCOLLUM. Your statement lives up to your reputation, and we are proud of that.

Mr. MURRAY. E.F. Hutton didn't tell me what to do, and none of the attorneys told me what to do, and I don't play games. Bottom line.

Mr. MCCOLLUM. And nobody above you in the Justice Department told you what to do?

Mr. MURRAY. Absolutely not.

Mr. MCCOLLUM. Let me ask, then, the bottom line question and see how much we can explore that in my limited time.

Mr. MURRAY. Sure.

Mr. MCCOLLUM. Why did you decide not to prosecute individuals?

Mr. MURRAY. OK. I will tell you.

One, we believed, ultimately, that the plea agreement was one that served the people, that there were possibly two or three individuals that might have been responsible for the conduct. The money mobilizer, I will tell you now, is the obvious person.

But what you have to do is look at the corporation that was acting collectively. It was a system that was in operation that the industry was approving their practice of aggressive cash money management that became the exception, that became the rule rather than the exception.

We believed, also, that it would be tough to prove. We bullied them around. I bullied E.F. Hutton around, but the bottom line is that the banks, in a way—forgive me, bankers across the country—but the bankers were, in a way, in many instances, equally—I don't want to say "culpable." I don't want to use the word "culpable," but there is a love-hate relationship between the banks, and many of the banks knowingly approved this conduct and participated along in the actual practices.

The bottom line, that is the bottom line, and the fact of the matter is that a trial of this case, my so-called victims become in fact possibly the co-conspirators and defendants, and there is a possibility that there would be injury nullification because of that love-hate relationship. I took that very much into consideration. I will tell you something. I had a very difficult time in the grand jury and I can't tell you what happened. I would go to jail.

Mr. HUGHES. We don't want to know.

Mr. MURRAY. I won't tell you, but I will tell you. It was like pulling teeth from the bankers, because there is an interwoven business relationship between corporate America and the banks, and nobody wants to accuse E.F. Hutton of committing a crime and nobody wanted to say that these practices might be fraudulent because in fact many of the banks in this country are doing the same thing. They are teaching it.

They are taking advantage of availability and collectability, every single time I write a check there is an analog between every single time I write a check on deposit and get availability or use of those funds and what the bank does in fraud. I will explain to you specifically. For instance, the $400——

Mr. MCCOLLUM. All you are telling us, you would have had a great deal of difficulty in proving the case against individuals and that is one of the reasons why you did not prosecute?

Mr. MURRAY [continuing]. That is right, because the individuals, I believe, other than Mr. Morley, and maybe one other person, thought they were acting in accordance with industry practice, in accordance with what the other corporations are doing, in accordance with the services that the banks are providing them. And the reason why the banks in this country provide that service is because they make money off the float.

If E.F. Hutton is involved in a check-writing scheme and starts depositing funds in the banks, if the banks rush quickly enough to the Federal Reserve System, they pass on the risk of loss to the people of this country. That is the bottom line. I would have taken a risk if I had nothing in my hand. If I had no plea agreement, would I have in fact gone to trial? Yes.

Mr. MCCOLLUM. But you believe that the plea agreement was the appropriate method to go?

Mr. MURRAY. Yes. We were able to dictate the terms of a cash management practice that heretofore had not been defined. John and I, Peter and Bob sat up for months to develop the seven various injunctive provisions to stop these practices and to set guidelines. If we had gone to trial, we would never be able to do that and we would have had chaos. The bottom line, I would have taken it, if I was in the Middle District of Pennsylvania, it was handled there, I would have taken a one-count felony plea with injunctive relief.

Mr. MCCOLLUM. You are saying the practices you were able to stop by this plea agreement instead of trying individuals is something that would have been going on to this day if you hadn't accepted a plea agreement; is that correct?

Mr. MURRAY. That is correct. I mean, individual prosecution is important. We all know that. That is my policy. It has always been my policy. In my whole career I have only taken one corporate guilty plea. This was an exception to the rule. This was a novel issue.

I was not going to jeopardize the health of, what I believe to be the M1 in the banking industry, which I hope the banking committees will start looking into, for the purposes of trying to indict one individual and throwing away, you know, its just not practical, plus the courts, that person wasn't necessarily going to go to jail. That person was going to say I did what the First National Bank of Chicago told me to do.

Mr. McCollum. It sounds to me like what you did from what you have explained so far is eminently reasonable, but I want to listen to the rest of the questions.

I think my time is up. Thank you very much, Mr. Chairman.

Mr. Hughes. The gentleman from Florida, Mr. Smith, is recognized for five minutes.

Mr. Smith. Thank you, Mr. Chairman.

Mr. Murray——

Mr. Murray. Yes, sir.

Mr. Smith [continuing]. It was about a little less than 2 years from the time that the postal inspector approached you with what was a complaint from the banks in your district?

Mr. Murray. Yes, sir.

Mr. Smith. Which he had reason to believe may have been a violation of Federal law, correct?

Mr. Murray. The postal inspector?

Mr. Smith. Yes.

Mr. Murray. No; he didn't really know. The way we operate together is we sit down and we review the activity together. He felt that it was in his function to present those cases. He is a friend of mine.

Mr. Smith. And from that point forward you felt that there was sufficient basis to move ahead?

Mr. Murray. I thought it was something that needed to be looked into, because I personally didn't understand what was going on, yes.

Mr. Smith. You looked into this from May 1982?

Mr. Murray. Yes, sir.

Mr. Smith. In April 1984 you issued target letters?

Mr. Murray. Yes, I did.

Mr. Smith. To that first group of people?

Mr. Murray. Yes, I did.

Mr. Smith. Up to that point had you been to the grand jury?

Mr. Murray. I had been to the grand jury with subpoenas and returning documents to the grand jury, and also, yes, in January and February we started our first live testimony after review of the documents up to that point in time, yes.

Mr. Smith. The target letters that went out, did they result in all of those people appearing before the grand jury?

Mr. Murray. No; those people claimed that they were not guilty of any crime. They took the Fifth, and I did not immunize them.

Mr. Smith. You didn't ask for relief?

Mr. Murray. Absolutely not. I was not going to immunize those people at that time.

Mr. Smith. So at that time you didn't have any idea whether or not in fact you were going to bring them in and indict them or whether you would ultimately dispose of the case in another manner. At that point you didn't know and you didn't want to risk the loss or the ability to indict these people?

Mr. Murray. That is exactly right, that is exactly right.

Mr. Smith. At some point in time obviously you began to see a large scheme emerge in this process?

Mr. **Murray**. That is correct.

Mr. **Smith**. I would assume that it took a while, but eventually the magnitude of it, and the uniqueness of it began to make itself quite apparent as it has to us?

Mr. **Murray**. Yes.

Mr. **Smith**. And all of us are attorneys, so I assume we look at things more or less the same way, although I was never a prosecutor. Let me ask you this, because you talked about the plea arrangement so what you felt in the best interests, so much in the best interests——

Mr. **Murray**. Oh, yes.

Mr. **Smith** [continuing]. Of the people of the United States, and that the decision not to prosecute was based on that plea arrangement which, if you wouldn't have had, you would have prosecuted because you felt that there weren't that many people who you could prove a case against; is that correct? I mean, let's assume you could have proved——

Mr. **Murray**. Essentially.

Mr. **Smith** [continuing]. That 20 or 30 individuals at E.F. Hutton, from way up at the top of the corporate ladder to as far down as it would have gone, would have been people who knowingly and willfully entered into a scheme to defraud the people who were their customers and the banks, would you have indicted, if you had felt that there were that many people and not gone into the plea arrangement?

Mr. **Murray**. If I had felt that there were that many, no, I wouldn't. I felt—the only way I can answer that is I felt that the whole system in my theory—it may differ from a lot of people—the whole system was operating as a fraud.

I felt that in essence there were 17,000—I am sorry, that is wrong. Anybody who was involved in the interbranch system of checks and disbursement that touched a check that was deposited and then withdraw a DTC in an amount over and above the customer money possibly had liability.

If you buy my theory that the practice of aggressive cash management is in fact, can be proved to constitute a scheme to defraud, so in essence what I had was a situation where I had not 20 or 30 or 40 but maybe 5,000 people operating in an entire system.

Mr. **Smith**. Down to the branch manager level and possibly even the people that advised the branch managers in their own branch?

Mr. **Murray**. Exactly correct.

Mr. **Smith**. Now, obviously you felt a scheme to defraud would be very difficult to prove. The *Williams* case is to some degree a difficult obstacle.

Mr. **Murray**. And *Frankel*.

Mr. **Smith**. Well, that is what I want to get into for a minute. There was a concurrent investigation going on in other areas, I think also in the New York area, by the U.S. attorney, of these practices, with the Genesee Bank; is that correct?

Mr. **Murray**. Yes.

Mr. **Smith**. Eventually you chose to use your district as the forum for venue, brought to the grand jury sitting there on these cases?

Mr. **Murray**. That is correct.

Mr. **Smith**. And eventually filed in the middle district in Scranton?

Mr. **Murray**. The middle district in Pennsylvania.

Mr. **Smith**. Which is contained within the Third Circuit, the only circuit that has the *Frankel* case applicable, correct?

Mr. **Murray**. Well, I would think that other jurisdictions, Second Circuit, et cetera——

Mr. **Smith**. Well, they are not bound by that. It is a circuit case.

Mr. **Murray** [continuing]. It is the law.

Mr. **Smith**. I understand it is the law.

Mr. **Murray**. I know. I didn't mean to say that you didn't.

Mr. **Smith**. No, no, I understand. But the *Frankel* case did not exist in other circuits. It was the Third Circuit case, correct?

Mr. **Murray**. Sure.

Mr. **Smith**. I would assume you would feel bound by the *Frankel* case, and the *Frankel* case says in essence that check kiting under the circumstances, I think you sought, was almost impossible to prove?

Mr. **Murray**. Let me just explain that this is not technically check kiting, and I will explain to you why, and I will explain to you why there ere certain activities that were considered check kiting. I anticipate what you are going to ask. The question is why did you move to venue Second District where you weren't bound by Frankel. The bottom line is that the case had been referred to an office in the Southern District of Pennsylvania for certain activity. What the activity was is a man having flipflopped, or the daylight overdrafts occurring, and it wasn't being pursued.

The reason why it wasn't pursued, because they felt *United States* v. *Williams* prevented them from pursuing the case. Second, the reason why we didn't take venue of the case is because we believed, I believed that in the event that the case was in fact referred—the Buffalo office I believe did not pursue it. The venue was properly laid in the middle district of Pennsylvania. It was a referral letter to the Southern District, and nothing happened with the case. It just died out.

Mr. **Hughes**. The gentleman's time has expired. The gentleman from Florida, Mr. Shaw, is recognized for 5 minutes.

Mr. **Shaw**. Mr. Murray——

Mr. **Murray**. Yes, sir.

Mr. **Shaw** [continuing]. On your investigation we have the cash concentration problem and the practice that we all know about. Did you look at the bill-paying side of the bank accounts, and did you find evidence of the same type of practice on that side as you did in the side which has been under investigation by this committee?

Mr. **Murray**. The disbursement system wasn't specifically addressed in the criminal information or the civil injunctive proceeding. However, by implication it is addressed in the system.

I haven't been able to explain the scheme to you. I don't know, but the two systems of checks and disbursement systems in this country, corporate structure, are interconnected in that monies that are in the concentration system go to fund the disbursement system, so that there is float in the concentration system, and there is also float in the disbursement system.

Any ability or desirability of a corporation to create float can be done on a disbursement side or the concentration side. What we specifically looked at was a disbursement technique in the concentration side, which was being abused. Yes, there is a clause—the specific answer to your question. We did not specifically deal with it, because what the Federal Reserve's policy on disbursement is they frown on it.

We, in our injunctive proceedings, say anything that is designed to create float in the banking system, the implication is, is something that we are going to look at as a possible scheme to defraud, and that would take within it the scope of a disbursement system, although the abuses of this, the criminal prosecution, related specifically to the concentration abuse, and the concentration abuse was based upon controlled disbursement techniques which in fact were used unlawfully in the concentration system, which I will explain to you if you would like.

Mr. SHAW. Do you have an opinion as to whether there should be changes in the Federal law, or do you think the enforcement procedures or regulations could be changed in order to deal with the situation as it is today?

Mr. MURRAY. Oh, most definitely. I saw one of the key things I think that New York State just did. I am not really particularly certain on this. But on the disbursement side, New York I believe requires now that if you are going to make a payment to a customer, securities, that the disbursement be made within the New York area, that it be made in a location of the customer.

In the Hutton system, the disbursements were made from a California bank, Bank of America, to all its various customers. What that does is it extends the float. You play the float on the disbursement side. I think there is a change to be made whereby a law can be enacted whereby the disbursements to a customer of their funds be made locally, that the availability that the bank grant you on those funds be equalized and put more in line with the Federal Reserve rule of the 1- or 2-day rule, which allows the banks on its deposits to grant, to have availability of those funds within two days, regardless of the length of time it actually takes that check to be collected.

That to me is where legislation is ripe, is to balance that, because there is an inequity in the banking system, whereby you and I are not allowed to use the availability of that, in fact corporate America can within 1 or 2 days. Yes, it is ripe in that. Also it is ripe and a lot of these things build me up, but the automated clearinghouse. That is a means in which wire transfers or electronic fund transfers can now be used. The cost is high now.

However, if the government decides to mechanize the system to the Federal Reserve, what in fact will happen is that cost will be reduced. As that cost would be reduced and the Federal Reserve is allowed to use its RCPC's regional checks with the automatic clearinghouse, it will reduce the float across the country which will reduce ultimately federal float, which in 1979 was $6 billion a day. Now it is less than $1 billion. So I think there are many, many areas that the legislation can be had in which changes can be made to benefit the country.

Mr. SHAW. Mr. Murray, I just have one other comment. In listening to your testimony this morning, looking at the history and the background with regard to this whole case, it is very clear at least to this Member that you are a young David that went after Goliath and got him. I would compliment you. You are a credit to the service. I think that your judgment was very well exercised and I just wish we had more like you. Thank you.

I yield back.

Mr. HUGHES. The gentleman from Kentucky is recognized for 5 minutes.

Mr. MAZZOLI. Thank you, Mr. Chairman, and thank you, Mr. Murray.

Mr. MURRAY. Good morning.

Mr. MAZZOLI. I am sure your dad is very proud of you as a person and how you have handled a very difficult situation. It is not easy to sit at that table and to hold forth with Members up here. Let me ask you just a few questions.

Mr. MURRAY. Surely.

Mr. MAZZOLI. I am very much impressed by the way, the words you chose to express your own individuality, your independence, your own decisionmaking capabilities. I am sure that that is exactly the case.

Let me just ask you a couple of questions about that. One is you are an assistant U.S. attorney. You are not the U.S. attorney.

Mr. MURRAY. That is correct.

Mr. MAZZOLI. In your office in the middle district of Pennsylvania, how are decisions reached? I mean, could you sort of in a succinct way describe how, when you get a case, you are then responsible afterwards, or to what extent does the superior have some ultimate responsibility?

Mr. MURRAY. Our district is a medium size office. It is basically not a large office where there is a lot of step authority where you have a chief and a chief chief and a lot of chiefs and the Indians are way down here. We are a spread-out district. We represent the largest geographic district in Pennsylvania, and when we have full staff—and we are now understaffed—I would like to have some more—we have approximately 10 AUSA's and we are all pretty much independent, because of the fact—I am not saying that I am so great but we are all very experienced trial attorneys, and basically we make our own decisions.

What we do is bring the cases to the U.S. attorney, and then we tell him basically what we believe to be the situation. We don't have a chief of the criminal division or whatever.

Mr. MAZZOLI. So this case was assigned to you by rotation, or was it because you had the experience or because your U.S. attorney felt that this case would take that kind of Goliath-David treatment that required your sort of tenacity?

Mr. MURRAY. I know you are being flattering.

Mr. MAZZOLI. I am trying to.

Mr. MURRAY. It was assigned to me because my friend Dick McGee comes in and we are sitting down there and we are dreaming of things and we are saying, "Boy, we don't understand what is going on here. Let's find out what E.F. Hutton is doing." And I went in to David Queen, who has been U.S. attorney, and I said, "Dave, can I take a look at this? Just let me play around with this a little bit and see what this is because I really don't understand what is going on."

Mr. Mazzoli. And that is fairly typical with cases. In your 6 years that is how cases get started?

Mr. Murray. Yes.

Mr. Mazzoli. And you sort of have a little idea?

Mr. Murray. Indeed, yeah, and Dave had confidence that I will look at it, I will be thorough in looking at it.

Mr. Mazzoli. Would days go by that you didn't check with the U.S. attorney?

Mr. Murray. Oh, of course. All I do basically——

Mr. Mazzoli. Would weeks go by that you wouldn't check with him on specifics of the case?

Mr. Murray. No; I wouldn't say that. What I would do generally is give—in all honesty I can give Dave a report.

Mr. Mazzoli. A memo or some sort of a staff report?

Mr. Murray. Well, not a memo. I would now and then provide Dave, if he needed—he was the head of the office. I respected him as the head of the office.

Mr. Mazzoli. You keep him posted——

Mr. Murray. Basically.

Mr. Mazzoli [continuing]. On remarkable developments, but not the unremarkable ones? You sort of keep him posted on status of the case; is that it essentially?

What I am really asking is you did not have to get his John Hancock on papers or authorizations or in effect authorities for you to then take them whether to Mr. Holland or to anyplace else. You pretty much acted as the decisionmaker in your office with respect to the E.F. Hutton case?

Mr. Murray. Yes; and what I would do is I would then report to Dave since he is the ultimate person to make the decision, and try to convince him, "Dave, please, let me stay on E.F. Hutton."

Mr. Mazzoli. Let me ask you this. Did the U.S. attorney, whoever it was at the end of the time here, did he or she swear off to go on to your decisions of settlement of these 2,000 cases of wire fraud?

Mr. Murray. Dave had left. Dave Queen left January 14. He had left by that time. Dave and I had numerous discussions about the case, but he had left at that time. We had talked about corporate liability, criminal liability, individual liability, how complex a case it was. He had left by that time, so he was not a part of that decision. The ultimate decisionmaking process, although he was a part of the process to issue subpoenas, et cetera.

Mr. Mazzoli. Let me speak about Mr. Trott, then. To what extent was this decision on your part which was to say that the settlement which you achieved with this five- or six- or seven-point injunction was the best for the United States of America, its people and the banking system, to what extent was that brokered with Mr. Trott, submitted to Mr. Trott, analyzed with him, amended by him, modified by him; to what extent did that take place?

Mr. Murray. Basically, Steve's position—I call him Steve because I have a lot of respect for him.

Mr. **Mazzoli**. It is his first name. It is logical. Call him Charley and that maybe would be a little difficult.

Mr. **Murray**. But Steve basically took the attitude, a pretty hard-nosed attitude about it, that in accordance with our policy, too, that individuals and corporate liability is basically, is what we, you know, look for, and that only in exceptional circumstances could he be convinced that in fact a corporate criminal plea in this type of situation would be appropriate, so basically what I have to do along with Peter and Bob and John is convince Steve Trott, Steve, that in fact this was in the best interests of the country.

We pretty much had to fight and scratch with him to convince him of that, and that was the second tier because the first tier I had to kind of fight and scratch to say, "Steve, I think this ought to be a criminal case."

Mr. **Mazzoli**. I don't know how much time I have left. Let me go back just a half a second. You said you had to sort of arm wrestle with Mr. Trott with respect to going along with this because he wanted to not do anything or get to Mr. Fomon.

Mr. **Murray**. Yes; he wanted individuals to be prosecuted if in fact there was proof beyond a reasonable doubt that those people were in fact guilty. He wanted individuals incorporate plea, if possible.

Mr. **Mazzoli**. The argument you had to make, which was made persuasively, was that that type of approach was not either feasible, possible, but would have destroyed the M1 system and the other things that you talked about, and that therefore this settlement, many counts of wire fraud, fines, reserves, injunctions, was the best remedy; is that correct?

Mr. **Murray**. That is correct.

Mr. **Mazzoli**. May I, Mr. Chairman, just for one half a second, proceed on one quick question? My time has expired. I am sorry.

Mr. **Hughes**. The gentleman from California for 5 minutes.

Mr. **Lungren**. Thank you, Mr. Chairman.

Welcome, Mr. Murray. It is a pleasure for me to hear from you.

Mr. **Murray**. Thank you.

Mr. **Lungren**. Sometimes hearings like this and other hearings have consequences. Sometimes we enact legislation. We provide oversight. At the same time the press is always here writing its stories, and on days like this I would rather be a member of the press than a member of Congress, because the story I would like to write would suggest that one assistant U.S. attorney went after a case that no one else had gone after for various reasons, went after a case despite the fact Congress had left a lot of loopholes in the law with respect to bank fraud.

Mr. **Murray**. Don't hurt yourself.

Mr. **Lungren**. No, I am serious, because the point is that I have read stories in the press which have suggested that the Justice Department dropped the ball, that they were lenient, that because of political pressure they did not go after individuals, that they played footsies with big business, that they are not serious about white collar crime, and the story is exactly the opposite.

Without your efforts, this case would never have been developed, because we really didn't have a case like this before. I think you have pointed out part of the reason was the acquiescence of the banks in the activities of E.F. Hutton, no one wanted to be the first person to point the finger.

And so if nothing else I hope this hearing points out your statement as I understand it, that you were the one that had this case from the beginning and continue to have it; is that correct?

Mr. MURRAY. That is correct.

Mr. LUNGREN. You have been in charge?

Mr. MURRAY. That is correct.

Mr. LUNGREN. The recommendations that you made as to the disposition of the case up to this point have been followed?

Mr. MURRAY. Yes, and I will defend it until I die, yes, that is right, that is correct.

Mr. LUNGREN. Let me just zero in on a couple of things that unfortunately have appeared in the media. The media suggested that a lunch between Mr. Fomon and former Attorney General Smith influenced the decision to extend the grand jury.

As I understand it, that lunch took place on November 15, 1984. When did you learn of the decision to extend the grand jury.

Mr. MURRAY. I had talked about extending the grand jury with Dave Queen approximately a month or so before we actually extended it. Neither one of us was basically kind of happy about it, extending the grand jury, because we had gone like 2 years and we wanted to get this thing over with.

Like enough is enough, and we were all kind of tired, so Dave and I had talked about it and we weren't happy about extending but I was recommending to Dave, you know, I think maybe I need some more time to really polish it, but then we had nothing, and as a result of having nothing nets a guilty plea from Hutton or anything except the individuals saying we didn't do anything wrong, I started to prepare along with John Holland a proposed indictment.

What happened was that the grand jury was extended before the decision was made, before any meeting with the big muckity-mucks.

Mr. HUGHES. Can we establish some dates?

Mr. MURRAY. I think that Mr. Fomon appeared before the grand jury on November 8. I think the meeting as I understand it, was like November 15. I think we extended the grand jury in front of Judge Rambo on the 6th, around the 16th. I didn't find out until a little after that, about the meeting, maybe a week or so later after that.

We had no idea about that. The decision to extend the grand jury had nothing to do with Mr. Fomon going around trying to meet with the then Attorney General.

Mr. LUNGREN. Let me ask you, did you perceive any political pressure from the Department to extend the grand jury?

Mr. MURRAY. Political pressure? Political pressure?

Mr. LUNGREN. That is what I am asking.

Mr. MURRAY. No, absolutely not. It was a decision that was made in order to polish the case, to allow also Hutton the opportunity and the individuals an opportunity to be, to also be heard, because that is something I had agreed to and everybody had agreed to before. It had nothing to do, it had nothing whatsoever to do with any meeting between anybody. I just told you that.

Mr. LUNGREN. I would be surprised to see if that appears in the press.

Mr. MURRAY. I think that has just been something that is blown way out of proportion. I think it is pandering to the public, I think, in my opinion

Mr. LUNGREN. You did mention——

Mr. MURRAY. It helped my case.

Mr. LUNGREN [continuing]. You did mention that you had hoped in some respects that with the activity that you were engaged in, the prosecution you were engaged in, that at some point in time Congress would pick up the ball and perhaps do something with respect to further laws involving the banking system, and as I understand it, in the Comprehensive Crime Control Act, we did make some changes in the bank fraud statute.

Mr. MURRAY. Yes, but in 1984 you did.

Mr. LUNGREN. Which went into effect after——

Mr. MURRAY. Right.

Mr. LUNGREN [continuing]. The subject matters of your investiation, your prosecution, correct?

Mr. MURRAY. Yes.

Mr. LUNGREN. So it was not available to you at that time?

Mr. MURRAY. No. It wasn't available to me at that time. In 1984 it was, but at that time I was prosecuting, it wasn't available. Thank goodness you all did that. I guess you all did that 1344 and 1345 but when I was investigating this case in 1982 that was not available.

The *Williams* case was just coming down. *Frankel* happened, I believe, in 1983. There were several other cases that were affecting the ability to prosecute any scheme that might sound like, smell like or act like a check kite, so I didn't have that. Now the tool is there now to make a check or representation or whatever.

We had to form what we call our own scheme to defraud, and we did that in kind of a unique way which hopefully I will be able to explain, so our scheme was really, we developed that scheme, and it fitted within the mail fraud, wire fraud statute.

Mr. LUNGREN. That is another point I would like us to stress. You basically had to engage in some rather I will use the term inventive prosecution to fit your case within the parameters of the admittedly incomplete law that we had existing at that time?

Mr. MURRAY. Well, the problem was technically is that the use of the zero balance account, and that tool as an extension of credit, took it outside of the definition that *Williams* had made it regarding what a check kite would be, so by the use of the zero balance account that took it outside of the parameters, so therefore, you couldn't use that theory.

Whether it would be in the southern district of New York, in the second, or any, district of New York, that theory could not be basically used.

What we had to develop was a scheme to defraud that in fact the use of the checking accounts, the DDA accounts, was not being used properly, and what the scheme was, the practice was, which is called aggressive money management, was in fact an atttempt to use—create float and expand the fabric within the payments mechanism without the knowledge, the full knowledge of certain banks, so we developed that scheme.

Mr. Hughes. The gentleman's time has expired. The Chair recognizes the gentleman from Connecticut for 5 minutes.

Mr. Morrison. Thank you, Mr. Chairman.

Mr. Murray, in addition to being a member of this subcommittee I am a member of the Banking Committee, and I appreciate your comments in that regard, and will be glad to receive from you or anyone else at Justice suggestions about how the banking laws ought to be changed, and I am pleased to report that the Banking Committee has reported out funds availability law which at least takes some steps in the direction that you have suggested.

Mr. Murray. Thank you.

Mr. Morrison. And I would also like to say that while I will have some questions about your decisions and how they were gotten, whether they were yours, Mr. Trott's or anyone in between, I certainly join my colleagues in commending you for the tenacity with which you have pursued this case, and I think we have all been well served by that, and whatever the bottom line on E.F. Hutton, it is certainly the case that we have discovered some things about the banking system that will benefit all of us.

I would like to talk a little bit in more detail on the subject that Mr. Lungren was just pursuing with you, about the grand jury extention.

Mr. Murray. Sure.

Mr. Morrison. Now you said, I would like to kind of pin the dates down a little bit, if we could.

Mr. Murray. If I can.

Mr. Morrison. You said November 16 was the date on which the motion was made in the court.

Mr. Murray. I believe that is what it was. Peter Clark and I talked about extending it about a week or two or three before that, yes.

Mr. Morrison. Now when was the first discussion that you can recall about extending the grand jury?

Mr. Murray. The first discussion with whom?

Mr. Morrison. That you participated in?

Mr. Murray. With what person? What person are you talking about?

Mr. Morrison. When was the first time you talked to anybody about extending——

Mr. Murray. I talked to Dave Queen about it. We talked maybe a month, a month and a half, about a month before, before the expiration of the grand jury, that——

Mr. Morrison [continuing]. A month and a half. The grand jury was scheduled to expire on what date?

Mr. Murray [continuing]. Sometime in November, I believe, right after Thanksgiving it was scheduled to terminate.

Mr. Morrison. So sometime in the beginning of October; is that what you are saying?

Mr. Murray. No, November.

Mr. Morrison. No, no, I am sorry, the date that you——

Mr. **Murray**. I don't know specifically the date. It was sometime in October when we had a discussion about whether or not we should go ahead and extend the grand jury.

Mr. **Morrison** [continuing]. Who initiated that discussion?

Mr. **Murray**. We probably both did. It was a mutual discussion between both of us.

Mr. **Morrison**. How did it come up?

Mr. **Murray**. How did it come up?

Mr. **Morrison**. Yes.

Mr. **Murray**. In discussing basically the case. Al, how are you doing, how is the case coming along? We had presented it to one grand jury. That grand jury had expired. We were now going to—we were reaching the expiration date of another grand jury. What is the status of the case. How are you doing, you know, that type of thing.

Mr. **Morrison**. Was the nature of the discussion the difficulty in securing an indictment from this grand jury or something else?

Mr. **Murray**. Well,the nature of the discussions were when we had a finished product, whether or not we were ready to go, whether I thought, I thought, we were ready to present the matter to the grand jury, and indict the matters at that time, because we were under time constraints, and what happened at that time we had nothing. We had no plea agreement. We had, Hutton was denying any type of liability, so we were talking about—excuse me, we were talking about needing additional time.

Mr. **Morrison**. I understand, but what I am getting confused on is that each time you have discussed this you talked about having nothing, and the nothing I hear you having is essentially a plea agreement, an offer to concede liability as opposed to the evidence and the case necessary to indict, and those are two different things. Which was it?

Mr. **Murray**. It was both. It was a combination of both. We were still generating evidence. We had 7 million documents. We were still generating the evidence on the chains. We were still generating the evidence as far as the excessive drawdowns, as far as the drawdown sheet. We were still gathering information. It was a combination of both. We were negotiating both at the time with the company.

Mr. **Morrison**. When was the decision made subsequent to that to actually go to the court and ask to extend the grand jury?

Mr. **Murray**. That was made I think it was made on November 13 or 14. That was when I had a discussion with John Holland and I told John Holland, I think I told John Holland, what we would do. Instead of extending the grand jury for 30 days or whatever I wanted it extended for 6 months.

I wasn't really happy about extending it because we were all kind of under the gun but that we were going to extend it for 6 months to allow me, to allow us all to polish the case, to allow Hutton to go down to Justice at that time and make their presentation, to allow Hutton to talk to us about a presentation, because I had agreed to that.

Mr. **Morrison**. When did that enter the case? When did that aspect of going to Washington, to Justice, in other words, to explain? You talked about target letters that you sent out in April, which were in part to allow people to present exculpatory materials.

Mr. Murray. That is correct.

Mr. Morrison. Were those presentations made to you at that time, after those target letters?

Mr. Murray. Those presentations were made to me not in April. It was made I believe later on in November or December.

Mr. Morrison. When did the idea of giving Hutton a chance to go to Washington, why did Hutton have to go to Washington? Why couldn't they just come to you?

Mr. Murray. Oh, because Hutton had always claimed that it hand't done anything wrong, and that my investigation was a sham, and I was bullying them around, that I was off on some wild—I am just going to tell you, I was off on some wild tangent and Tom Curnin and I had a discussion about it and I said, if you don't think I am doing right, call the Department. Get in touch with the Department.

Mr. Morrison. When was that discussion?

Mr. Murray. That was many times. That was in 1982, 1983. It was continuous. Hutton's attitude towards me that I was off the reservation. I was in some, I was doing something that nobody else was doing, and therefore they wanted an opportunity—excuse me—they wanted an opportunity to have my decisionmaking process reviewed by somebody other than Al and Holland.

Mr. Morrison. They started asking for that in 1982?

Mr. Murray. In oral discussion with me and Tom, Tom said, I want the Department, I want to go over your head, Al, if I can.

Mr. Morrison. And you said fine, go ahead?

Mr. Murray. I said fine go ahead. I can't stop you from doing that. Go on.

Mr. Morrison. So what was special about 1984 to give them a chance to do this? Why couldn't they have done this in 1982, 1983 or the first 11 months of 1984?

Mr. Murray. They could have but you know why they didn't? They didn't want to bring attention to the grand jury investigation. They didn't want to give me credibility. What they were trying to do is they thought I was going to go away so it was their strategic, their lawyer's tactic, their lawyer's tactic not to let the Justice Department know about it because then what it would do it would give me credibility.

And what they were thinking between 1982 and 1984 that the investigation was over when they started inundating me with 7 or 8 million documents that we really weren't going to pursue it so they thought the case was dead while he was also as a lawyer taking the strategy but maybe also if we start to make it, I am going to see the Department. That is what had happened.

I am just going to tell you that is how it happened. He tried to take a strategic legal advantage on me because he didn't tnink that I was going to continue.

Mr. Morrison. I am afraid my time has expired. I hope for a chance to continue this.

Mr. Murray. Oh, fine.

Mr. Morrison. It is very fascinating but my time has expired.

Mr. Murray. All right. Thank you very much.

Mr. **Hughes**. The Chair recognizes the gentleman from Pennsylvania for 5 minutes.

Mr. **Gekas**. I thank the Chairman. Just quickly, I just caught the tail end.

Mr. **Murray**. Oh, boy.

Mr. **Gekas**. But I am being briefed on what you have been saying and how you are responding and I am grateful for your testimony. I have been concerned throughout all of this as to whether the principals, and you were one of the principals in this whole thing, were taking into consideration the innocence in this whole thing. For instance, the employees of Hutton, the standard office employee, 17,000 of them I think across the country, and also the victim banks who were in it also.

Mr. **Murray**. Well, I wouldn't necessarily say that.

Mr. **Gekas**. Well, I don't say that they are all in it, but the people who were investing in the bank, the employees, all that sort of thing.

Did that process, did that enter into your thinking process in the actions you were taking when you came to the conclusion that plea bargaining was in the best interests of people concerned in this?

Mr. **Murray**. Ultimately it did. My general strategic prosecutive strategy is to go from the bottom to the top, and then assume that criminal culpability exists on all levels against everyone, and then exclude them. I am not the kind—you know what I am saying?

In other words, I will write out a list of subject targets and try to exclude individuals. Yes, I was concerned that the branch personnel basically had no criminal culpability as I saw it, because they were following what they believed to be corporate policies, that while they were implementing the guidelines, they were following corporate policies.

I then looked at the regional level to see what they were doing. The regions believed they were also implementing corporate policies. I then looked at the higher level, and tried to find out what they were doing. They were saying there was nothing wrong with crediting float, that yes, we set forth the policies, but we weren't actually implementing anything.

You had something like this. They had a top pointing down and down pointing up top. They were both pointing at one another, and the reason why they were doing that is because the top was setting the policies of basically go out and create float, because everybody else does that.

It is aggressive money management practices, and what they did in this decentralized corporation, they allowed the regions and the branches to implement those practices. I believe that the collective—it was a collection of all the various employees in the inner branch system, which operated, which was causing the entire company to operate fraudulently, but that individual parties were operating under the assumption that they were aggressively managing their cash, and did not have that form of criminal intent, when I looked to industry practice, which was doing the same thing. I hope I answered your question.

Also, I might indicate that you were closer to this case than you think. Are you from Harrisburg?

Mr. **Gekas**. Oh, yes.

Mr. **Murray**. Many times I saw you in the cafeteria and there were Hutton people right next to you. You didn't know it. I thought that was you.

Mr. **Gekas**. Is that right?

Mr. **Murray**. That is right.

Mr. **Gekas**. What was I drinking?

Mr. **Murray**. Well, I don't know.

Mr. **Gekas**. The only other question I wanted to ask, maybe you have already answered it pursuant to some question posed before I came to the meeting. How did you handle the final announcement or break to the media of this whole thing, and keeping these considerations all in front of you, as you were doing it, how did you frame how you were going to get this to the media?

Mr. **Murray**. Well, OK. With all due respect, maybe one of the problems in this case was that there was a type of a media and political hysteria, because for 3 years we worked pretty much without anybody knowing what we were doing, and all of a sudden on May 2, we laid this big deal on the company, on the world, I guess it is the world, and they wonder whether or not this was some back office stuff going on.

I didn't care about the media. We thought about it. We thought about it, but I guess I made a mistake, because one person from—excuse the media, I guess they are here—said to me, call me, he said, Al, your big mistake in this is that you didn't leak it to the press. If you had leaked it to the press ahead of time we would have had some background on it and we would have known a little more about it.

I said, I just don't do those things. There are certain people that do those things without leaking it to the press and defame people's character without ever having a conviction.

John Holland and I and Peter and Bob, we just didn't do that. We just won't do that, but what happened I think on May 2 all of a sudden it is kind of incredible all of a sudden here is E.F. Hutton, 2,000 counts, you know, the largest case in America, blah, blah, blah, blah, blah, blah, and how come nobody knew about it. If I was the public I would look at it and say, something must be wrong here, but you know, and especially I am trying to explain a complicated scheme, and nobody understands it because the media told me that they write things, and I love the media, don't want the media to think I don't like them, they are nice people, that they write these bylines so people can easily understand the most complicated thing I know that you will see, it is one of the most complex schemes ever prosecuted.

The problem is mainly there weren't any leaks. There just weren't. I mean I had some of the highest officials of E.F. Hutton and of the corporations across the country sitting in Harrisburg, sitting right next to you, and nobody picked it up.

There was never one comment in the press from April 14 or May when we started to the present, other than one disclosure that was made in the 10K by the company, and I got one call on that from one reporter who says, hey, is something going on? What is going on up at Scranton and I said, no comment. Nobody did anything. I wasn't going to leak it.

John Holland and I and the Department weren't going to leak it until we beat them in court. We are not going to defame anybody in public. I have no great love I will tell you, but I am not going to unfairly leak a grand jury investigation, and possibly hurt them and all their investors and shareholders, whatever, before I have proven that a crime was committed.

I don't do that kind of thing, but it is kind of incredible that the press didn't pick it up. I am glad they didn't because then what would have happened if they had done that I think what would have happened Hutton would have complained about prosecutorial misconduct, they would have asked the Department to come in, these guys are trying to railroad us and possibly the case would have been influenced by that.

So with all due respect to the media, whether we want me to leak it or not I will never do it, in none of my cases.

Mr. Gekas. I Thank you very much. I yield back the balance of my time.

Mr. Hughes. The Chair would observe that a vote is in progress, so we are going to recess for 10 minutes and come right back.

[Recess.]

Mr. Hughes. The subcommittee will come to order.

I apologize for these interruptions, but that is one of the unfortunate parts about trying to conduct hearings during the session of Congress. We are interrupted a number of times, and we apologize for those delays.

Let me see if I understand correctly. From your testimony, Mr. Murray, from the time you picked up the case in mid-1982 until about mid-1984, you basically developed the case, you and John Holland. You had periodic contacts with Peter—with the U.S. attorney, Mr. Queen, at that time. But, in essence, you were the lead counsel; you were in charge of the case. You actually were pursuing the leads.

Mr. Murray. That is right.

Mr. Hughes. I presume that by the time mid-1984 came about, June 1984 or thereabouts, most of the legwork in the case was done.

Mr. Murray. Well——

Mr. Hughes. There were additional subpoenas issued subsequently. You didn't get all the evidence you were after. However, the bulk of the work was done.

Mr. Murray. Well, I think——

Mr. Hughes. By mid-1984.

Mr. Murray. Well, the scope of the whole investigation changed in——

Mr. Hughes. That was not my question. I am talking about the basic legwork.

Mr. Murray. No. Well, it wasn't. I think maybe—-you know, I tried to let Dave know it was done, and we tried to let some of our superiors believe that it was done because there was a problem. There was a problem keeping the investigative agencies on the case.

So I want to be perfectly clear, that basically, no, the bulk of the work was done but there were very important parts——

Mr. Hughes. That was my question.

Mr. Murray. But when we say "bulk of the work," there is a conclusion in there. There were a lot of outstanding things. For example, we had not prepared our document with control lists at that time. We had not gone through with our exhibit lists at that time. We had not prepared Brady material. We had not prepared Jencks material for discovery if we had gone to trial. We had not completed our review. We changed the scope of our investigation and we found out that we were going to attack the drawdown sheet and operation of the drawdown sheet differently. We decided to change the scope of the whole thing.

Mr. Hughes. That is basically trial strategy, is it not?

Mr. Murray. Excuse me?

Mr. Hughes. Trial strategy, basically?

Mr. Murray. That is what we were preparing for. Ultimately, we were trying to formulate the grand jury investigation and evidence collecting into trial strategy, and working into the trial strategy we had to decide whether or not we needed additional grand jury investigation. So, therefore, when our scope changed, we then changed the necessary work that we had to do.

So, to say altogether that the bulk of the work was done is really not correct because we changed strategy around that time. I can explain to you the strategy——

Mr. Hughes. It also is a fact that as of the date of the plea bargaining you had not received all the documents you had subpoenaed; is that not so?

Mr. Murray [continuing]. That is absolutely correct.

Mr. Hughes. Isn't it also so that you received evidence that certain documents were destroyed?

Mr. Murray. No. We made that allegation, I believe. What we had——

Mr. Hughes. That was baseless?

Mr. Murray [continuing]. No, no, no. We—that was sort of a—you know what that was? That was Mr. so-and-so—I can't believe that if you carbon copy four or five people that in the document production we wouldn't have received four or five copies.

Mr. Hughes. I am going to offer for the record——

Mr. Murray. Can I——

Mr. Hughes. Let me just have you look at something. I think it is unfair for me to ask these questions without giving you the document.

I offer for the record a document dated March 5, 1985, directed to Tom Curnin, and ask you if that is the document you sent to him?

[The document follows:]

AVAILABLE

U.S. Department of Justice

United States Attorney
Middle District of Pennsylvania

12-16

EXPRESS MAIL

Post Office Building
Washington & Linden Streets
Scranton, Pennsylvania 18501

717/348-2800
FTS/592-8301

March 5, 1985

Thomas F. Curnin, Esquire
Cahill, Gordon and Reindel
80 Pine Street
New York, NY 10005

RE: Grand Jury Investigation
E.F. Hutton and Co., Inc., et al
No: 82-0196

Dear Mr. Curnin:

Enclosed herein please find the following Grand Jury Subpoenaes:

[redacted] Our office acknowledges and appreciates prompt production of documents once they are in your possession. Our great concern is your client's failure to produce critical Grand Jury evidence. It is becoming quite apparent that your client is attempting to intentionally thwart the Grand Jury's investigation. Our inventory of records and my own personal review of our files indicates that we have not previously received the

Moreover, we have recently obtained information that this document, as well as others, may have been intentionally destroyed as a direct result of the Grand Jury's investigation. Tom, as you know, this is a serious matter and must be addressed.

We expect to receive all documents kept within the normal course of business, including

No further extensions of time will be granted.

Thank you very much.

Yours very truly,

JAMES J. WEST
United States Attorney

Albert R. Murray

ALBERT R. MURRAY, JR.
Assistant U.S. Attorney

JJW:ARM:jak
cc: Robert W. Ogren, Esquire
Chief Fraud Section
U.S. Dept. of Justice
Criminal Division
Washington, D.C. 20530

John Holland

Peter Clark

Mr. MURRAY. I know the document. I am familiar with the document.

What that document is saying, I believe—I told him that I was having a serious problem with the fact that document production had not been made promptly. I could not understand where the documents were. We basically had some kind of belief that maybe there had been a destruction of documents. That related to the document relating Perry Bacon to the Bacon-Brayloff memo.

I couldn't understand why now just getting that document—that was a key document in the case—why we were not getting that document when it was carbon copied to four or five other people. As a result of a meeting we had in the Justice Department, I, along with Peter Clark, started to, as we say, rake Mr. Bacon over the coals, and we got nebulous answers as to why that document was not kept in his files.

Mr. HUGHES. I share your frustration because this committee has had the same problem.

Mr. MURRAY. Let me tell you, you know, the problem is——

Mr. HUGHES. The problem is on the documents.

Mr. MURRAY [continuing]. Let me tell you, the problem we had is we would get a document from the E.F. Hutton that had on it, carbon copy, 30,000 people, for example. Yet, when we got the document, we would get one copy. But we asked for any and all documents from everybody's records. That would mean, to me, logically, if it was carbon copied to a branch manager in Wisconsin, or Norm Epstein, we would have gotten 30 copies. Instead, we got no copies at all and don't have the original, or—you know.

So I was questioned whether that was either sloppy document control or destruction of——

Mr. HUGHES. I don't want to listen to that further. We have limited time here.

Mr. MURRAY [continuing]. Excuse me.

Mr. HUGHES. I want to bring to your attention a statement contained in that letter to Mr. Curnin.

Mr. MURRAY. That was my statement.

Mr. HUGHES. We have recently obtained information that this correspondence may have been redescribed. "Tom, as you know, this is a serious matter and must be addressed."

Mr. MURRAY. That is right.

Mr. HUGHES. As of November 11, 1984, you did not know the grand jury was going to be extended, did you?

Mr. MURRAY. November 11, I believe—was that Veterans Day?

Mr. HUGHES. That was the weekend you and the postal inspector were preparing indictments.

Mr. MURRAY. We were discussing it. I was discussing it. John didn't know about it. I was discussing it with Peter Clark. We were preparing an indictment to get ready to go.

Mr. HUGHES. Mr. Holland knew about it because Mr. Holland filed a report.

Mr. MURRAY. I know that. I am saying nothing that John did—didn't interpret what I would tell him. I never kept anything from John. John knew what I was—I knew what I was going on, and John knew.

Mr. **Hughes**. It is safe to say that as of mid-1984 you were still handling the case, however?

Mr. **Murray**. Yes, sir.

Mr. **Hughes**. No question about that?

Mr. **Murray**. Yes, sir.

Mr. **Hughes**. There came a time when Justice in Washington decided that supervision was going to shift from Scranton to Washington. When did that come about?

Mr. **Murray**. OK. That happened as a result——

Mr. **Hughes**. The date.

Mr. **Murray** [continuing]. A couple things occurred.

Mr. **Hughes**. I asked for the date, the day.

Mr. **Murray**. The specific date?

Mr. **Hughes**. Yes.

Mr. **Murray**. I think the specific date was a letter that was—forgive me on the date—a letter from Mr. Trott to Mr. Queen in December 1984. That letter indicated that—I believe to the best of my recollection—that I would be lead counsel and trial counsel; that I was going to work under—along with Peter, Peter Clark; that I was going to work under the supervision of Bob Ogren, Chief of the Fraud Section, and Bob would report to Victoria Toensing, as a result of Dave Queen leaving the U.S. attorney's position.

Mr. **Hughes**. I will offer a letter dated December 31, 1984 from Stephen Trott to David Queen indicating Al Murray shall remain as lead lawyer, and he and Peter Clark shall report directly to Bob Ogren, who, in turn, will report "through Victoria Toensing to me."

That is the letter you refer to, December 31, 1984?

Mr. **Murray**. Yes, sir.

Mr. **Hughes**. That is when that became effective?

Mr. **Murray**. Yes.

Mr. **Hughes**. Any objection?

So ordered.

[The letter follows:]

U.S. Department of Justice

Criminal Division

Assistant Attorney General

Washington, D.C. 20530

December 31, 1984

Hon. David D. Queen
United States Attorney
Post Office Box 309
Scranton, Pennsylvania 18501

Dear David:

Just a note to confirm our conversation last week about the Hutton case. Effective with your resignation, direct supervision of the case will be transferred to the Criminal Division in Washington. In that regard, although Al Murray shall remain as the lead lawyer and number one chair on the case, he and Peter Clark shall report directly to Bob Ogren who in turn shall report through my deputy Victoria Toensing to me. Between now and your departure, it is expected that you will continue to work on the case and give us the benefit of your analysis of it before you leave.

Good luck in your new job. I look forward to continuing to work with you in your capacity with the Department of the Treasury.

Sincerely,

Steve

Stephen S. Trott

cc: D. Lowell Jensen
John C. Keeney
Victoria Toensing
Robert Ogren

Mr. SMITH. Will the gentleman yield?

Mr. HUGHES. Be happy to yield.

Mr. SMITH. I thank the gentleman for yielding.

The document just offered by the chairman, the letter sent by Mr. Trott to David Queen——

Mr. MURRAY. Yes, sir.

Mr. SMITH [continuing]. Indicates that effective with his resignation and his—basically his kick upstairs, that he was going to be transferring direct supervision of the Hutton case to Washington.

Mr. MURRAY. Yes, sir.

Mr. SMITH. Did they directly transfer supervision of any other of the cases to Washington?

Mr. MURRAY. I don't know what you mean. Sorry. Please forgive me. You mean any other cases that we had?

Mr. SMITH. Yes.

Mr. MURRAY. Oh, no, no. The reason why—no.

Mr. SMITH. Let me finish now.

Mr. MURRAY. Any other cases in our office, no.

Mr. SMITH. Mr. Murray——

Mr. MURRAY. Sorry. I tried to respond.

Mr. SMITH. The answer is no.

Mr. MURRAY. No.

Mr. SMITH. No, to transfer anything but supervision of the Hutton case.

Mr. MURRAY. Just Hutton.

Mr. SMITH. You testified before when Mr. Mazzoli asked you about your supervision in terms of the day-to-day relationship between yourself and Mr. Queen——

Mr. MURRAY. Yes.

Mr. SMITH [continuing]. How authoritative, how much independent your role was.

Mr. MURRAY. Yes.

Mr. SMITH. As manager of your own cases.

Mr. MURRAY. Yes.

Mr. SMITH. You said it was fairly extensive. You didn't have to go to Mr. Queen.

Mr. MURRAY. Yes.

Mr. SMITH. For any decisions other than very major ones, I would assume.

Mr. MURRAY. Yes, sir. That is absolutely correct.

Mr. SMITH. Why would it be necessary to transfer the Hutton case to supervision in Washington when no other case was transferred because of the resignation of Mr. Queen, when, in fact, Mr. Queen was not handling the Hutton case, but you were?

Mr. MURRAY. OK, because there was a vacuum in the U.S. attorney's position because Hutton—the Hutton case itself was—had nationwide implications, and Washington had already basically been involved with the Hutton case as far as Peter and I were involved, and that generally the acting U.S. attorney, James West, had no knowledge about the Hutton case.

As a matter of fact, we were in limbo for several months regarding an acting U.S. attorney. So there was a vacuum that was created.

Because Hutton had nationwide implications, it was a very complex matter; that the matter was then transferred down to Washington. Normally, I will tell you out in the field we don't like—we like to handle our cases—a Pennsylvania case, a middle district of Pennsylvania case is basically our case. Probably if Dave Queen had remained there, it would have been—we would have still joined in with the department on the case. But we probably would have ultimately made the final decisions in the case.

Mr. Hughes. Let me see if I can't develop the case.

Mr. Smith. I thank the gentleman for yielding. Thank you.

Mr. Hughes. There came a time——

Mr. Murray. Yes, sir.

Mr. Hughes [continuing]. In November, the early part of November, when you were preparing to present the matter to the grand jury.

Mr. Murray. Yes, sir.

Mr. Hughes. You worked that entire weekend.

Mr. Murray. Sure did.

Mr. Hughes. In fact, you worked both Saturday and Sunday.

Mr. Murray. I believe, yes.

Mr. Hughes. Yes.

Mr. Murray. And Monday.

Mr. Hughes. Preparing draft indictments.

Mr. Murray. That is correct.

Mr. Hughes. To present to the grand jury that following week.

Mr. Murray. That is correct.

Mr. Hughes. The grand jury was to expire on November 28.

Mr. Murray. I believe you are right, yes.

Mr. Hughes. Yes.

And on March 4, which is subsequent, obviously—March 4, 1985——

Mr. Murray. OK.

Mr. Hughes [continuing]. You had gotten to the point where you had—you were making proffers of individual targets.

Mr. Murray. Proffers?

Mr. Hughes. Proffers of individual targets as well as corporate targets.

Mr. Murray. That is correct.

Mr. Hughes. Regardless of whether or not a plea from the corporation was forthcoming.

Mr. Murray. I can't remember now. Let's see. That is correct. That is correct.

Mr. Hughes. I offer for the record a letter of March 4, 1985 from Al Murray to Peter Clark which—any objection?

Hearing none, so ordered.

[The letter follows:]

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U.S. Department of Justice

United States Attorney
Middle District of Pennsylvania

Post Office Building
Washington & Linden Streets
Scranton, Pennsylvania 18501

717/348-2800
FTS/592-8301

March 4, 1985

Mr. Peter B. Clark, Esq.
Trial Attorney
U. S. Department of Justice
315 9th Street, N.W.
Washington, DC

RE: E. F. Hutton Group, Inc., Et. Al.
Grand Jury Investigation
No. 82-0196

Dear Peter:

The following is an outline of Proposals which would be the skeleton of an equitable pre-indictment disposition for the corporate defendants ONLY.

As we have previously discussed, we will proffer individual targets, subsequent to the corporations acceptance or non-acceptance of these basics. Most of these items have been discussed with Tom Curnin, who agreed in concept, but of course made no commitment, desiring a civil disposition instead.

I am re-calculating the monetary/value-benefit of Hutton's scheme, and suggest we mention no definite total restitution amount, until determined. This sum may range from $15 million to $250 million depending upon how we want to present the calculations.

Fines and costs are at $5 million with Federal Reserve estimates at $15 million.

Albert R. Murray

Albert R. Murray, Jr.
Assistant U.S. Attorney
Middle District of Pennsylvania

Mr. Hughes. This letter discusses the terms, in turn, that proffer of individual targets as well as corporations regardless of the acceptance or nonacceptance of a plea from the corporation.

Mr. Murray. Yes.

Mr. Hughes. Your case was prepared and ready to go to trial as early as—to the grand jury as early as mid-November 1984, although——

Mr. Murray. No, that is not true.

Mr. Hughes [continuing]. Although, additional material was coming in and trial strategy was being developed.

Is that a fair assessment?

Mr. Murray. Of course, you would always be fair. But we were not—we were not ready to go in November. We would have presented an indictment——

Mr. Hughes. Who made the decision to actually extend the grand jury?

Mr. Murray [continuing]. I think it was a joint decision between myself, Peter Clark and Dave. The decision wasn't welcomed, as I remember. I wasn't crazy about it, I don't believe. But we felt—I felt in fairness that I had given my word in the past that the Hutton people would have an opportunity to come in and make a presentation to us as to why they believed they didn't commit a crime.

Mr. Hughes. Mr. Murray——

Mr. Murray. Excuse me. It was a joint decision among all of us.

Mr. Hughes [continuing]. Are you sure it was a joint decision, Mr. Murray? Are you positive of that?

Mr. Murray. What I am positive of is that I knew of the decision. The decision basically was one that the Department did not force them on us; indicated, however, that they——

Mr. Hughes. It is important for us——

Mr. Murray. I am going to tell you what I knew.

Mr. Hughes [continuing]. Let me ask Mr. Holland.

Mr. Holland, what is your recollection?

Mr. Holland, I have a copy of a memo that has been supplied to me by Justice pursuant to our request, prepared by your office on February 28, which at paragraph 2 recites the very things we are talking about, the expiration of the grand jury and the decision at that time to extend.

What is your recollection of who made the decision to extend?

Mr. Holland. My recollection—excuse me. I wasn't turned on. Excuse me.

My recollection as to who made the decision is based on information that I received from conversing with Al. I know I wasn't part of the decision, and I believe my recollection is that Al told me that the request had come from Justice.

Mr. Hughes. Let me just read, if I might—and tell me if this is accurate.

Mr. Lungren. Mr. Chairman, would you yield just a moment?

Mr. Hughes. Let me finish this line.

Mr. Lungren. None of us have copies of what you read.

Mr. Hughes. All right.

I offer for the record——

Mr. Smith. Everybody does. It is in your book.

Mr. Lungren. It is not in the book of those of us on this side of the aisle.

Mr. Hughes [continuing]. We will make copies. Let's take a minute and make copies.

The document is dated February 28, 1985. Subject is: Check Kiting; Alleged Violator: E.F. Hutton. And it is a report of the postal inspector.

I offer the document for the record. Is there objection?

Hearing none, so ordered.

[The document follows:]

U.S. POSTAL SERVICE
INSPECTION SERVICE

REPORT OF POSTAL INSPECTOR

TYPE OF REPORT
☒ PRELIMINARY ☐ FINAL
☐ SPECIAL ☐ SUPPLEMENTAL

OFFICE: Wilkes Barre, PA
ZIP CODE: 18701
DATE: February 28, 1985
CASE NUMBER: 115-2202318-F(1)

SUBJECT
Check Kiting - Alleged Violator:
E. F. Hutton, Court House Square,
312 N. River St.
TASK FORCE CASE - TEAM A
CHIEF INSPECTOR INTEREST

RESTRICTIONS
RULE 6E MATERIAL INCLUDED

POSTAL INSPECTOR: J. F. Holland /ag
POSTAL INSPECTOR IN CHARGE: Harrisburg, PA 17105-9000

REVIEWERS' INITS											
DATE											

DISTRIBUTION			ROUTING					
INITS	DATE	AGENCY	INITS	DATE	TO	INITS	DATE	TO
		Inspection Service ONLY			Chief Inspector			
		USPS			RCI			

1. Personal attention has been given this case at Harrisburg, PA; Scranton, PA; New York, NY; and Washington, DC on a continuous basis since submission of the preliminary report dated October 10, 1984. Basis for the case was a report dated March 19, 1982, sent to the Postal Inspector in Charge, Philadelphia, PA, by Joseph Nodla, an Examiner for the Federal Deposit Insurance Corporation, reporting an alleged check kiting scheme involving the E. F. Hutton Company, Inc., using an account at the United Penn Bank, Wilkes Barre, PA, among others.

2. As indicated in the latest preliminary report, the grand jury was scheduled to expire on November 21, 1984. During the weekend of November 11 and 12, 1984, Postal Inspectors J. C. Conroy and the undersigned assisted AUSA Albert R. Murray, Jr. in preparing a final draft copy of an indictment which was to be presented to the grand jury prior to its expiration. However, at the request of the Department of Justice, an indictment was not presented to the grand jury since the company and the targeted suspects had requested permission to speak directly with the Department of Justice prior to the presentation of an indictment. As requested by the Department of Justice, an extension of the grand jury for a period of six months was obtained from the Honorable Sylvia Rambo, Federal Judge, Harrisburg, PA. ① Attorneys for the company were requested to make written submissions to the Department of Justice after which a decision would be rendered. Beginning in November of 1984, the company began providing submissions to the Department of Justice,

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copies of which were presented to AUSA Murray. During the months of November and December, the company presented a total of five written submissions to the Department of Justice, as well as three written submissions on individual targets. The submissions were reviewed and found to contain little information of merit and a lot of misstatements of fact as well as half-truths. The submissions were critiqued by AUSA Murray and Postal Inspectors and the critiques were presented to the Department of Justice.

3. On January 7, 1985, a meeting was held at the Department of Justice in Washington, DC. Present at the meeting were Mr. Stephen Trott, Chief, Criminal Division; Mr. Robert Ogren, Chief, Fraud Section, Mr. Peter Clark, Trial Attorney, Fraud Section; Albert R. Murray, Jr., AUSA, Middle District of Pennsylvania; Mr. William G. Hundley, Hundley and Cacheris, Law Firm; Thomas F. Curnin and Thomas J. Kavaler, Attorneys, Cahill, Gordon and Reindel, Law Firm; J. Clayton Undercofler, III, Attorney, Dilworth, Paxson, Kalish and Kaufman, Law Firm; and Thomas Fitzpatrick, Attorney, as well as Inspector in Charge Thomas J. Dagley and the undersigned. The purpose of this meeting was to give the attorneys for the company, i.e., Hundley, Curnin, Kavaler, Undercofler and Fitzpatrick, the opportunity to make an oral presentation in addition to their written submissions. The meeting lasted for approximately 2 1/2 hours, after which the attorneys for the company were advised that a decision would be rendered and provided them after the prosecution team caucused. It became apparent after the meeting that the Department of Justice would authorize prosecution of at least the firm. Mr. Trott advised that due to the resignation of David Dart Queen as United States Attorney for the Middle District of Pennsylvania, Mr. Trott was taking over direct supervision of the prosecution of this case. He also advised that Mr. Murray would remain as lead counsel for the government. It was also decided that a decision relative to the culpability of individuals would be rendered after Mr. Ogren and Mr. Clark had occasion to review documents.

4. On two occasions during January and February of 1985, Mr. Clark and Mr. Ogren visited Division Headquarters in Harrisburg, PA for the purpose of reviewing documents relating to individuals' culpability in this case. While in Harrisburg on January 15 and 16, 1985, Mr. Ogren advised that the company would be notified the following week that it was to be indicted. He also advised that of the different fraudulent practices of the company that had been identified, the most appealing from a prosecutive standpoint were the chain link drawdowns, the purpose of which is the creation of float. Mr. Ogren requested additional investigative effort (charting) to further develop that aspect. Arrangements were made to identify and isolate approximately twenty horizontal drawdowns and six Postal Inspectors from the Eastern Region assisted Inspectors on this Task Force in charting approximately 190 months of activity.

5. Mr. Clark and Mr. Ogren returned to Harrisburg on February 7 and 8, 1985 to continue reviewing documents relating to individuals' culpability. Upon completion of this review, Mr. Ogren was satisfied that sufficient evidence existed for indicting individuals as well as the corporation. Mr. Ogren also determined that the activities of the company throughout the country should be charged in a conspiracy count in the indictment. This decision has necessitated verification of the charting previously done and will result in augmenting the Task Force with the individuals from the Eastern Region who previously assisted the Task Force in the original charting. It is estimated that two weeks will be required to complete this activity and that it will begin in Harrisburg on March 4, 1985.

6. At this point in time, there is one remaining project of major significance to be completed in this investigation. This project relates to document control. Over the past year, considerable effort was expended in inventorying the records in this investigation which number in the millions. An attempt was made at utilizing the 5520 System for inventorying and controlling the more significant of those documents. The effort was not successful. An article written by Barbara Nicastro, a Trial Attorney in the Fraud Section, Department of Justice, was recently obtained. In this article, Mrs. Nicastro explains a system she has developed for assistance in document control, retrieval and use at trial. The system she employs is a manual system for cases involving several hundred to several thousand records. The system employs a combination of numbers and letters affixed to documents which assist in not only identifying the particular document, but also locating the document, preparing witness lists, preparing trial exhibit lists and preparing source lists. Meetings have been held in Harrisburg, PA over the past two weeks for the purpose of devising a computerized system which will give us the same capability, i.e., document control, retrieval and use at trial. Inspector Raleigh Demby is in the process of writing a program based on information provided him by AUSA Murray and members of the Task Force. It is expected that the program will be available on March 6, 1985 and that beginning March 4, 1985, members of the Task Force, supplemented by Clerks from the Harrisburg Post Office, will begin a systematic inventory of all records which will be input into a system over the next several weeks. Inspector Demby advises that an IBM PC AT with a 40 megabyte drive will be required for this purpose. Attempts are being initiated immediately in locating a machine with that capability.

J. A. Holland
Postal Inspector

Mr. **Hughes**. I read from paragraph 2 of the document:

> As indicated in the latest preliminary report, the grand jury was scheduled to expire on November 21, 1984. During the weekend of November 11 and 12, 1984, Postal Inspectors J.C. Conroy and the undersigned assisted AUSA Albert R. Murray, Jr. in preparing a final draft copy of an indictment which was to be presented to the grand jury prior to its expiration.
>
> However, at the request of the Department of Justice, an indictment was not presented to the grand jury since the company and the targeted suspects had requested permission to speak directly with the Department of Justice prior to the presentation of an indictment. As requested by the Department of Justice, an extension of the grand jury for a period of 6 months was obtained from the Honorable Sylvia Rambo, Federal Judge, Harrisburg, PA.

The rest is not particularly germane.

Mr. **Holland**. That last sentence you read, Mr. Chairman, is in error, as I recall. I believe the decision to extend for the full 6 months was Mr. Murray's decision, and that was based on the fact that the grand jury can only be extended for one time.

Mr. **Hughes**. I see.

Mr. **Holland**. And you can extend it for a period of up to 6 months. So whether you extend it for 1 month or 2 or 6 months, it really didn't make any difference to us at that point in time.

Mr. **Hughes**. Insofar as the 6 months, that is erroneous. I understand.

Mr. **Holland**. That is right.

Mr. **Hughes**. But as far as the request coming from the Department of Justice, to your knowledge——

Mr. **Holland**. That information would be based on the information I obtained from Mr. Murray, because I did not enter into day-to-day discussions about the case with the Department of Justice.

Mr. **Hughes** [continuing]. I see.

Mr. **Murray**. Should I answer? I am trying to explain to you.

Mr. **Hughes**. Sure.

Mr. **Murray**. The Department of Justice—Peter and Bob and I discussed extension, the terms of the extension of the grand jury, because in response to Hutton we had not been allowed to make a presentation to us or the Department regarding their criminal culpability.

What happened was the grand jury was getting ready to expire. Dave Queen and myself, we had no plea agreement. We had no—the corporation was not going to plead guilty or nothing. So we were moving forward.

I want to explain to you actually what happened. I was there. And what occurred was that we said that, well, if the grand jury expires, we are not—we are going to lose the case. We won't have any case. So the best thing to do is to start preparing, preparing to present that, because we cannot present it to a third grand jury. It was too complicated.

So what we decided to do was continue to make that preparation. Then what happened, OK, Peter and I discussed, as I discussed, extending the grand jury for an additional period of time, for 30 days. Bob Ogren said we should do it 30 days and allow us, one, to clean up the case and get it in perspective, because we had not presented to the Department the full theories of the case, basically.

I said, "Fine, what will happen if we extend it, which you know I am not wild about it, but let's extend it," because I had given

Curnin and the company my word that they would be able to present their theory of the case to me; they would be able to present their theory of the case to the Department of Justice for review, because I had been rejecting them for 2 years. This was to allow for that opportunity and for us to put the case in order.

I wanted to tell you the truth.

Mr. HUGHES. I appreciate that explanation.

Mr. MURRAY. I am going to tell you that was the truth.

Mr. HUGHES. Obviously, there is some question in the record as the documents would suggest that the request came from the Department of Justice.

Mr. MURRAY. Well——

Mr. HUGHES. Let me just—the crucial point——

Mr. MURRAY. Mr. Chairman, I am just trying to——

Mr. HUGHES. The crucial point is that on November 11, you are preparing to take it to the grand jury. You are preparing to move it ahead to the grand jury. It is extended. The grand jury is extended.

Mr. MURRAY. Sure.

Mr. HUGHES. That week

Mr. MURRAY. Sure.

Mr. HUGHES. Was it Mr. Clark that appeared before the grand jury to move to extend?

Mr. MURRAY. No. Nobody appeared before the grand jury.

Mr. HUGHES. Appeared before the court to extend?

Mr. MURRAY. I appeared before Judge Rambo and presented a petition to extend the grand jury for an additional period of time.

Mr. HUGHES. What date did that occur?

Mr. MURRAY. I believe that was November—Friday, November 16, I think. We had been preparing the petition earlier that week, on the 14th, 13th, 12th, whatever. That was prepared down in the Department. I didn't feel like doing it. Peter did it and brought it up.

I am just going to say, that had nothing to do with the Fomon incident. I will just tell you that.

Mr. HUGHES. The point is, in all due deference, Mr. Murray, I know that you know what you know. But you don't know what others might have done up the line. That is the question.

Mr. MURRAY. Oh, yes I do.

Mr. HUGHES. Well, unless you have privy to a lot of conversations that take place at the Justice Department, you are preparing the matter for the grand jury on the 11th of November.

Mr. MURRAY. Yes.

Mr. HUGHES. Because you have a grand jury that will expire once again on the 28th.

Mr. MURRAY. Yes.

Mr. HUGHES. You have a luncheon taking place on November 15 between Mr. Fomon, the Attorney General, and others, the principal purpose of which was to talk about the extension of the grand jury.

Mr. MURRAY. The principal purpose as—excuse me. No, the——

Mr. HUGHES. I can just tell you that we have evidence that would suggest that that is the case.

Mr. **Murray** [continuing]. Well, I am just going to tell you what the truth is. You can draw whatever inferences you may from that situation. I am going to tell you what the truth is.

The truth is that the Fomon meeting with Smith had nothing whatsoever to do with the grand jury.

Mr. **Hughes**. Were you at the meeting, Mr. Murray?

Mr. **Murray**. Was I at the meeting?

Mr. **Hughes**. Yes.

Mr. **Murray**. No. I wish I had been at the meeting.

Mr. **Hughes**. You don't consider this anything improper about the Attorney General of the United States meeting with the chairman of the board of a corporation that is about to be indicted?

Mr. **Murray**. Well, I——

Mr. **Hughes**. Do you have any comment on that?

Mr. **Murray** [continuing]. I can tell you this: Two weeks ago I tried a case in front of the National Park Service against the defendant who wrote—excuse me, he wrote to his Congressman and was complaining about an activity, criminal activity, that he was being charged with. And the bottom line is he went directly to his Congressman, and the Congressman got in touch with me—and he shouldn't have gotten in touch with me.

I think what happened is this Mr. Fomon, as a result—I can't tell you how it happened—but as a result of what happened in the grand jury, was so scared that maybe his corporation was going to be indicted, that what he did is he ignored what his attorney had said. He ignored—ignored propriety and tried to do an end run. And you know what happened? It backfired on him.

Mr. **Hughes**. Well, the commissioner—Mr. Fomon—told the commissioner in Connecticut that—we have a transcript of it—that he didn't realize there were potential indictments going to be returned.

Did you see his testimony?

Mr. **Murray**. No, but you know what? I don't know what Mr. Fomon knew. You know why? Because I dealt with his attorneys, and what his attorneys told him I was not privy to.

I know one thing. He surely didn't know anything about this scheme, because when we started to tell him, he didn't believe we were serious in what we were doing.

So, I can't—half the information that E.F. Hutton put out after their plea of guilty was nothing but propaganda.

So, you know, I don't care what Mr. Fomon said. I know what happened.

Mr. **Smith**. Will the gentleman yield?

Mr. **Hughes**. Yes.

Mr. **Smith**. Mr. Murray, first of all, this committee is concerned with the propriety with what Justice did than of what Mr. Fomon did.

Mr. **Murray**. I agree.

Mr. **Smith**. I couldn't care less if Mr. Fomon violated the rules of justice. It is that the Attorney General of the United States agreed to meet with Fomon, not that he asked for the meeting. That is of no consequence.

Mr. **Murray**. But——

Mr. **Smith**. Mr. Murray, please. That is of no consequence.

Mr. MURRAY. Excuse me——

Mr. SMITH. I think the propriety of what Mr. Fomon did is not in question. It is the propriety of what was done by the Department of Justice.

What I think I would like to hear from you is an explanation of why it is you saw fit to work on the weekends, the weekend of November 11 and 12, when you have just told the chairman in response to his questions that the decision had been made prior to that time——

Mr. MURRAY. No.

Mr. SMITH [continuing]. To extend the grand jury.

Mr. MURRAY. I did not say that. What I said was that we had discussed the extension of the grand jury. I chose to work on the weekend because if the grand jury was not going to be extended, this case was going to be down the tubes, no nothing, and the only choice I had was to present what I had, and what we had to do is anticipate that maybe if the grand jury was not extended or the judge would not extend it, that we would have to return some type of a paper if this case was ever going to be prosecuted.

And if Judge Rambo said no extension, we would not present this case to another grand jury, and the prosecution would have been down the tubes. Period.

As a good prosecutor, what I did—as good——

Mr. SMITH. You were covering your bets.

Mr. MURRAY. That is right.

Mr. SMITH. Fine. I have no problem with that at all.

Let me ask you——

Mr. MCCOLLUM. Could we have regular order with this, Mr. Chairman?

Mr. SMITH. The gentleman will get his turn.

Mr. MURRAY. Excuse me if I was impolite in my answer.

Mr. SMITH. That is OK.

Mr. HUGHES. Mr. McCollum.

Mr. MCCOLLUM. Thank you, Mr. Chairman.

Mr. Murray, Al, we have had quite a bit of discussion now about this date period, and I am sure that the thrust is certainly as indicated in earlier commentary on the question of whether or not Mr. Fomon's meeting had anything to do with the extension of the grand jury proceedings since the occasion of the meeting with the Attorney General occurred so close to the time when the extension was granted, requested, whatever.

Mr. MURRAY. Yes, sir.

Mr. MCCOLLUM. Apparently, well, the record shows the meeting took place on November 15.

Mr. MURRAY. Yes.

Mr. MCCOLLUM. Did you know about the extension, the desire of the Department and others to ask for this extension before that meeting took place?

Mr. MURRAY. Yes.

Mr. MCCOLLUM. What type of discussion did you have that led you to believe that the decision was already made to extend or request the extension before that meeting took place? Before Mr. Fomon's meeting with the Attorney General took place.

Mr. MURRAY. As Mr. Smith said to me—Congressman Smith, I am sorry—I had discussion with Dave, I believe, Dave Queen, approximately a month before, concerning our preparedness to return an indictment.

I had also had discussions with Peter about it. I had discussions with other—with the investigative team about it.

I was concerned—I haven't said this, and I don't mean to offend anyone—but I was concerned over the fact that my investigative team might be pulled away from me, not by the Department of Justice, but as a result of the case lasting so long.

There were threats being made that the manpower in the team would be pulled away from me because of the fact I had not developed theories, we had not honed our theories down, and the case dragged on for 2 years, the investigation.

I was very much concerned that the case was—basically there was just going to not be—not going to be done at all.

So, we had discussions at the earliest a month before, and I was worried. I wasn't wild about extending the grand jury, only because of the fact that to extend the grand jury I was afraid that my postal investigation team would be disbanded.

Mr. MCCOLLUM. Mr. Murray—Al—the facts are you just said that you knew that this was, the request would be made to extend the grand jury before the meeting that Mr. Fomon had on November 15.

Mr. MURRAY. Yes.

Mr. MCCOLLUM. That decision was made. How did you know that? You had all these discussions for weeks going on before that, but was there—who had said to you and who had you agreed with or however that took place?

Mr. MURRAY. Peter Clark and I discussed it.

Mr. MCCOLLUM. And decided you were going to——

Mr. MURRAY. That we were going to extend it and that it was to hone the issues. It was to allow Hutton an opportunity for review which I had given my word they were entitled to, and I was hard nosing them and tried to make them kind of—it was to hone the issues to continue the grand jury investigation, to change the issues. It was an agreement that we had discussed.

Can I say one thing? The reason why I was not—I was not telling, in all honesty, the Department of Justice at that time that my investigative team was breaking up, because I didn't want them to think that we didn't have a case here. My investigative team was breaking up at the time.

Mr. MCCOLLUM [continuing]. You are talking about the postal inspectors, that crew?

Mr. MURRAY. Yes, from the standpoint that John and I—I hope you don't mind me speaking for you—we had to convince our superiors that we needed more help, we needed to continue to do the case.

Peter and I discussed it, discussed the matter. I discussed it with David Queen. The ultimate decision to extend the grand jury is made by Dave Queen. The U.S. attorney signs the document.

Mr. MCCOLLUM. And——

Mr. MURRAY. I don't think Dave——

Mr. MCCOLLUM. When did you make that decision?

Mr. MURRAY. I think over that weekend. I think I called Dave, told him that we were going to extend it, and I talked to the Department about extending it.

Mr. MCCOLLUM. You are talking about the weekend of the 11th and 12th when you were going into this preparation?

Mr. MURRAY. Yes, I think I called Dave over the holiday weekend. As a matter of fact, there are toll records. I called him Monday and said, "I think that is what we are going to do," and Dave said, "OK."

Mr. MCCOLLUM. Let me ask——

Mr. MURRAY. Then I think the meeting with Mr. Fomon—can I say one thing? The Fomon-Smith meeting helped my case.

Before that, my case had no credibility. I was yelling in the dark. There was a crime. I think I can prove a crime. Then the chairman of the board of Hutton goes and talks to the Attorney General of the United States.

That is you. That is the first time we had champagne. We said, "My goodness, we know this case is going to get prosecuted now, because this man is taking us seriously."

That helped my case. That didn't hurt, because at that time we had not had approval to even charge the case as a criminal case. So that gave impetus. It was the catalyst for us to now process the case. It wasn't anything to retard progress.

Mr. MCCOLLUM. What was the quality of those indictment papers that you had prepared that weekend that we are talking about—the 11th and 12th? You thought you might have to present something in case you didn't get the extension?

Mr. MURRAY. The papers presented, we never got a final draft of that indictment done, one.

Two, John and I discussed the individual liability of the entire—of the individuals. We were discussing that. We had not finished.

What we did, the papers that we were preparing related to the entire drawdown procedure. It related to the policy of the drawdown sheet and recapturing float. It included the manie-hanie flip-flops. It included the creation of float, excessive overdrafts. It was a wide smorgasbord of an indictment.

OK? Because it included all the activities. What we did in the investigation—the investigation revealed six areas that we believed to be ripe for possible fraudulent conduct. In that indictment, it was a smorgasbord.

Later on what happened, we boiled the issues down to actual provable issues, and that came down to ultimately what happened, the excessive overdrafting which I would like to explain to you what that means to some point and changing activities.

Mr. MCCOLLUM. What did you do after the extension to improve this paperwork and all the drafting of the charges and so on?

Mr. MURRAY. What did we do? Excuse me?

Mr. MCCOLLUM. Did you change the whole thing?

Mr. MURRAY. Oh, sure. What we did in the decisionmaking process, we tried to hone the issues down to the issues that would avoid the problems, the legal problems with the *Frankel* case and *Williams* case.

We tried to then boil it down to the excessive overdrafting which I would have to quantify and the chains. We felt, ultimately, the theory of the liability, criminal liability, could best be processed before a jury by those two theories, that in the event we had no plea agreement.

Mr. McCollum. You changed your whole theory of the case after that?

Mr. Murray. The whole theory of the case after that changed.

Mr. McCollum. After the extension?

Mr. Murray. Yes.

Mr. McCollum. You were not as well prepared or even prepared at all to go to trial when——

Mr. Murray. No.

Mr. McCollum [continuing]. You were trying just in case but by the seat of your pants is what it sounds like.

Mr. Murray. I wasn't totally prepared, but what I was trying to do is force the company to sit down, I mean, force the company to sit down at the table and bargain with me in the middle district.

Mr. Hughes. The gentleman's time has expired.

The Chair recognizes the gentleman from Florida, Mr. Smith, for 5 minutes.

Mr. Smith. Thank you, Mr. Chairman.

Mr. Holland, that memo which the chairman referred to and which a copy was provided to you and to Mr. Murray, in paragraph 3—both 2 and 3—the part that wasn't read by the chairman, and then in 3 talk about the fact that during the time that the grand jury was extended, that 6-month period, there were to be submissions made by the company to the Justice Department in Washington with copies to Mr. Murray which would then be reviewed by the Department and Mr. Murray.

Mr. Holland. Yes.

Mr. Smith. Then it talks about a January 7 meeting at the Department of Justice in Washington where you were, both Mr. Murray and yourself, together with Mr. Ogren and Mr. Clark and a number of others, including Mr. Trott, were present.

In that—towards the end of the paragraph, Mr. Trott says, Mr. Trott advised that, due to the resignation of Mr. Queen as U.S. attorney for middle district, Mr. Trott was taking over direct supervision of the prosecution of the case.

Now, Mr. Murray testified before at the very outset of his testimony that he was in charge of this case from the beginning to end. You were at the meeting. You wrote that Mr. Trott was taking over direct supervision of the prosecution of this case.

Mr. Holland. That is correct.

Mr. Smith. That does not exactly square with Mr. Murray's belief that he was in charge of this case.

Mr. Holland. I think it does, Congressman, because prior to this date, the direct supervision of the case lay with Mr. Queen in the middle district of Pennsylvania.

Since Mr. Queen had now resigned from the office, Mr. Trott logically filled that vacuum in providing the direct supervision of the case.

Mr. Smith. You heard Mr. Murray testify. This is kind of outside your area, but you heard Mr. Murray testify that no other criminal cases were transferred by virtue of the resignation of Mr. Queen.

Why would you say it is logical for this case to be transferred directly to the supervision of Mr. Trott when no other criminal case in the Harrisburg office was transferred, although the U.S. attorney had resigned, and not only that he was sent to Washington?

Why didn't they have him continue? Was there any discussion of Mr. Queen continuing his supervision of the case?

Mr. HOLLAND. Mr. Queen was no longer there.

Mr. SMITH. Didn't he go to Washington?

Mr. HOLLAND. Not with the Department of Justice.

Mr. SMITH. OK. So he was out of there.

Mr. HOLLAND. Correct.

Mr. SMITH. And they took this case, and Mr. Trott at that meeting announced that he was going to directly supervise?

Mr. HOLLAND. That is correct.

Mr. SMITH. All right.

Mr. HUGHES. Will the gentleman yield to me just on that point?

Mr. SMITH. I would be happy to yield.

Mr. HUGHES. I think Mr. Holland's explanation is really understandable, because Mr. Queen went with the Department of Treasury at that time, as I recall.

But there is one significant thing that changed right there, and that is contained in the last sentence of the paragraph. Up until that time, it was Mr. Murray that was making decisions with regard to individual culpability and charging.

And in that last sentence, and I read it, "It was also decided the decision relative to the culpability of individuals would be rendered after Mr. Ogren and Mr. Clark had occasion to review documents."

That was a major change in the oversight of the case.

Mr. MURRAY. Excuse me. I know you say that, but it really wasn't from the—was John answering? Sorry.

Mr. HOLLAND. If I could explain what I wrote in the report, and I would couple it with Mr. Murray's previous testimony.

The grand jury was extended in November, much to the dismay of a lot of individuals, both in our service and outside our service, because of the tremendous amount of manpower that had already been committed to the case at that point in time.

Up until that time, we had in excess of 15,000 manhours devoted to this investigation. Our service, and rightly so, was ready to see some results.

However, the extension of the grand jury in November probably resulted in the greatest amount of evidence that we had obtained during the entire course of the investigation between the period November 1984 and February 1985.

With the extended grand jury, additional witnesses were called before the grand jury and additional evidence was obtained during that interim period.

We became a lot stronger. The longer this case was continuing at that point in time, the stronger and more confident we became. It was actually the best thing that could have happened for the case.

One of the remaining——

Mr. HUGHES. Would the gentleman yield further?

I don't doubt that one bit, because the evidence would seem to support that, but the point I was making——

Mr. HOLLAND [continuing]. I was about to get to that.

Mr. **Hughes** [continuing]. By Mr. Ogren and Mr. Clark on individual culpability. Up until that time, it was Mr. Murray that was the lead counsel for the case.

Mr. **Holland**. Mr. Murray continued to be the lead counsel and what was happening at this point, at this period in time, was that the Department was reviewing the case. We had lived with the case for a good several years at that period of time, and the Department was also providing its review of the case.

And the Department came to Harrisburg shortly after this report was submitted or after the time referenced in this paragraph, reviewed the evidence and gave a fresh approach, a fresh look to the case.

They saw the conduct that they considered to be the most egregious conduct and recommended—and we welcomed the recommendations—that those were the areas in which we should concentrate our efforts.

Mr. **Smith**. Mr. Chairman, if I can reclaim my time.

I would like to get to that line exactly, so you will have an opportunity to finish this, Mr. Holland.

Going further in your memo of February, you indicated that on two occasions—paragraph four:

> On two occasions during January and February of 1985, Mr. Clark and Mr. Ogren visited Division Headquarters in Harrisburg, Pennsylvania for the purpose of reviewing documents relating to individuals' culpability in this case. While in Harrisburg on January 15 and 16, 1985, Mr. Ogren advised that the company would be notified the following week that it was to be indicted.

Going to paragraph five now:

> Mr. Clark and Mr. Ogren returned to Harrisburg on February 7 and 8, 1985 to continue reviewing documents relating to individuals' culpability. Upon completion of this review, Mr. Ogren was satisfied that sufficient evidence existed for indicting individuals as well as the coporation. Mr. Ogren also determined that the activities of the company throughout the country should be charged in a conspiracy count in the indictment."

You were privy at necessary meetings when Mr. Ogren was there in Harrisburg, correct?

Mr. **Holland**. Yes.

Mr. **Smith**. You were an attendee?

Mr. **Holland**. Yes, sir.

Mr. **Smith**. You had no reason to disbelieve that Mr. Ogren had made a valid decision that there was sufficient evidence for individual indictments, did you?

Mr. **Holland**. Well——

Mr. **Smith**. You had no reason to disbelieve that, did you?

Mr. **Holland**. No, sir.

Mr. **Smith**. You had lived with the evidence for a couple of years.

Mr. **Holland**. Right.

Mr. **Smith**. You have indicated in your testimony to the Chairman that they gave a second look at all the evidence at the time that they first came to the decision that Mr. Trott would be the lead—excuse me, the supervisor on the matter, and that Mr. Clark and Mr. Ogren would also get involved; that the fresh look, in fact, it did give you a greater ability to make the case, correct?

Mr. **Holland**. Yes, sir.

Mr. **Smith**. Now, let me go to you, Mr. Murray.

Mr. **Murray**. Yes, sir.

Mr. **Smith**. Obviously there were no criminal indictments against any individuals.

Mr. **Murray**. No, sir.

Mr. **Smith**. Just 3 months subsequent to the meeting of February 7 and 8, where Mr. Clark and Mr. Ogren both—and Mr. Clark is the Chief of the Frauds Division in Washington.

Mr. **Murray**. Yes.

Mr. **Smith**. Correct?

Mr. **Murray**. Correct.

Mr. **Smith**. Mr. Ogren rather.

Mr. **Murray**. Mr. Ogren.

Mr. **Smith**. Mr. Ogren—excuse me, is the Chief of the Frauds Division.

Mr. **Murray**. Right.

Mr. **Smith**. And Mr. Clark was the lead counsel?

Mr. **Murray**. Lead counsel of what?

Mr. **Smith**. Wait a minute.

Mr. **Murray**. I am lead counsel.

Mr. **Smith**. No, no, in Washington.

Mr. **Murray**. I am sorry?

Mr. **Smith**. I am doing this from memory.

Mr. **Murray**. Peter is helping me.

Mr. **Smith**. Trial attorney.

Mr. **Murray**. No, Peter was helping me. I am lead counsel. Peter was helping me. Basically he was telling, you know, Bob what I was doing.

Mr. **Smith**. But he was not a clerk. He was not a functionary. He was a senior trial attorney who had trial experience——

Mr. **Murray**. Sure.

Mr. **Smith** [continuing]. In trying these kinds of cases. Mr. Ogren——

Mr. **Murray**. Not these type of cases, not like this.

Mr. **Smith**. Fraud cases?

Mr. **Murray**. Yes.

Mr. **Smith**. Thank you. Mr. Ogren was a significantly high individual in the department, the Chief of Fraud Section, correct?

Mr. **Murray**. He is a career prosecutor like I am, yes.

Mr. **Smith**. And I have respect for what you do. I want you to know that. I think that you have an enormous future ahead of you based on what you did in this case.

Mr. **Murray**. I didn't do it for the future.

Mr. **Smith**. Excuse me.

Mr. **Murray**. I didn't do it for my future and own benefits. I did it because I thought it would benefit the country.

Mr. **Smith**. I didn't say you did it for your future. I said you have a good future.

Mr. **Murray**. Thanks.

Mr. **Smith**. But if the three of you—at least two of them, Clark and Ogren and possibly you as well, and Mr. Holland indicated he felt there was nothing wrong with the conclusion they came to.

Mr. **Murray**. Yes.

Mr. **Smith**. Had all decided that there was individual culpability and individual indictments would lie. Just 3 months later the Department all at the same time, Mr. Murray——

Mr. **Murray**. Yes, sir.

Mr. **Smith** [continuing]. Filed a plea, the disposition and the charges, the charges, the plea, the disposition.

Mr. **Murray**. Yes.

Mr. **Smith**. Filed all at the same time. You mentioned before that the media was surprised.

Mr. **Murray**. Yes, they were.

Mr. **Smith**. I will bet you Judge Rambo was surprised as hell.

Mr. **Murray**. Judge Rambo didn't take the plea. Who took the plea was Judge Nealon.

Mr. **Smith**. Whoever it was.

Let me ask you what can you tell us now to shed light on why just 3 months prior to the time you filed the charges and the plea and the disposition, Clark, Ogren, Mr. Holland, by his own testimony now, and possibly you—and I hope you will enlighten us during the course of the answer as to whether you subscribed to their belief—had made a decision that individual indictments would lie and yet the Department went ahead and filed no individual indictments.

Mr. **Murray**. The Department didn't do that. I made the recommendations along with the Department that the corporate plea was in the best interest of the people of this United States, because in essence to in fact reject a plea agreement that made the cash management system of this country and set guidelines for it was more, in my considered opinion, and maybe you might think it is different, than to involve ourselves and to indict two what I considered to be low-level employees of E.F. Hutton & Co. that may not have even occurred.

We may not even have gotten a conviction from possibly 88 or 89, and that in the event that was more important to set guidelines and to set precedent in an area that affected all of us then in fact to reject a plea agreement with these provisions than to just, than to go to a trial that was risky at best.

Mr. **Smith**. Would you have done that anyway if you had indicted both corporate and individuals, could you not have taken a corporate plea and still continued the indictments?

Mr. **Murray**. No. You know why? No. I will tell you exactly.

Mr. **Smith**. I would like to know why because it is available under the law.

Mr. **Hughes**. The time of the gentleman has expired.

Mr. **Murray**. I shouldn't answer?

Mr. **Hughes**. Go ahead and answer the question.

Mr. **Murray**. Because in the plea agreement if this matter had gone to trial against companies and individuals, we would not have been able to get total restitution for the banks. Two, we would have not been able to get the injunctive procedures which now creates for the first time in this country a mechanism whereby the banks, whereby cash managers now have to disclose their practices to the banks. We would have not been able to get an injunction that says and sets forth precedent that creating float through the intentional overdrafting of a bank account can constitute a scheme to defraud.

We could have gotten—the fine was insignificant. The $2 million fine to a multibillion-dollar corporation was not important to us at all, and not important to me. What was important was setting forth the guidelines in a civil matter and to also say that it subjects you now for the first time in this country to a criminal prosecution; that it was both a criminal and civil disposition, because all the ills that we found, Mr. Smith, was contained not only in the criminal prosecution, but also in the civil disposition. And I can at some point in time explain to you all the various schemes that we uncovered.

We would not have been able to get that in a trial, and we may not have even won the trial because of the chaos.

Mr. HUGHES. The time of the gentleman has expired. Of course, I might just say to the witness that that is always the case. Your job as a prosecutor is to present the case to a jury and let the jury decide the facts and the judge instruct in the law.

Mr. MURRAY. No, my view as I—yes, you are right, but my job is to do justice.

Mr. HUGHES. The system is there to do justice, and you are part of the system of justice.

Mr. MURRAY. But sometimes the system of justice doesn't——

Mr. HUGHES. Your job is to present sufficient evidence upon which to move forward, to secure an indictment and provide information and move on the matter on the basis of the evidence that you have before you, and let a jury decide whether it even is adequate to prove beyond a reasonable doubt whether the defendant did in fact commit the offense charted.

Isn't that in the province of a jury to do that?

Mr. MURRAY. That may be the overall theory of thought in the legal system, but the job that I see is for us to prosecute very very firmly and hard, the people, the situations that in fact have committed evil, but to also balance that with the overall good for the people, to balance that with the overall good to an industry practice that is threatening the banking society.

Mr. HUGHES. I understand. I am not quarreling with that.

Mr. MURRAY. What is so important about that?

Mr. HUGHES. I am not quarreling with that. The only thing I took issue with you on——

Mr. MURRAY Yes, sir.

Mr. HUGHES [continuing]. Is your fear that a jury might return a not guilty verdict. That is always the fear when you go to—I tried cases for 10 years, and sometimes I am astounded at some of the verdicts that come in.

Mr. MURRAY. I am sure——

Mr. HUGHES. But our province is to present as fairly and as impartially as we can——

Mr. MURRAY. With all due respect, I am sure the chairman has also taken guilty pleas from people and not chosen to go to trial based upon several——

Mr. HUGHES. Exactly. In fact I said at the very outset——

Mr. MURRAY. That's right.

Mr. HUGHES [continuing]. One of my first discussions with Mr. Trott was over—you indicated that my belief was it is easy to a Monday-morning quarterback, and I would just hope that this committee doesn't find itself in that position. We are trying to get the facts today.

Mr. **MURRAY**. I am trying to give them to you, and I will stay here all day to give them to you.

Mr. **HUGHES**. The Chair recognizes the gentleman from California.

Mr. **MURRAY**. Thank you, sir.

Mr. **LUNGREN**. Thank you, Mr. Chairman. I hope in fact we aren't Monday morning quarterbacking here. I would like to know in your position with the Justice Department, are you capable of signing an indictment yourself?

Mr. **MURRAY**. Me?

Mr. **LUNGREN**. Yes.

Mr. **MURRAY**. No. I sign—one, I wouldn't do it, and, two, no, I sign—I would like for——

Mr. **LUNGREN**. U.S. attorney.

Mr. **MURRAY** [continuing]. The U.S. attorney has to sign the indictment or whoever is higher than them alternatively. The U.S. attorney has the authority. I don't.

Mr. **LUNGREN**. So you don't have the authority.

Mr. **MURRAY**. No.

Mr. **LUNGREN**. You, yourself, couldn't have done that if you wanted to.

Mr. **MURRAY**. No; I couldn't have indicted this case myself.

Mr. **LUNGREN**. Let me just say something for the record, because it was brought up in previous questioning, and I don't want the record to just sit there as it is and be reported that way.

Since it was the gentleman from E.F. Hutton who contacted Mr. Smith through Mrs. Smith, an invitation to the Smiths, to have what they thought was a social luncheon. It was held at the Jockey Club in Washington. It was a social luncheon to the very end, when the gentleman from E.F. Hutton brought up the subject, at which point the Attorney General said he wasn't going to discuss it; left, and went back to the Department and contacted Mr. Trott.

Mr. **MURRAY**. That is my understanding.

Mr. **LUNGREN**. I would just like that to be on the record, because I think that there was a suggestion that somehow it was improper for the Attorney General to be involved in that, and I think the record ought to be clear.

Mr. **HUGHES**. Would the gentleman yield?

Mr. **MURRAY**. You bet.

Mr. **HUGHES**. We would be able to establish that, I hope, at the next hearing. I don't know that anybody really at this point for the public record has the facts, but we will try to establish that at the next hearing.

Mr. **LUNGREN**. Mr. Chairman, I have the right to state the facts as well as anybody else on this committee, and there have been statements made and the story is ongoing, and the story will appear about this hearing, and it may make allegations, and the person involved whose name has been brought up won't have an opportunity to respond to the day. And I think it is very important.

As long as we are not Monday morning quarterbacking here, I hope we will be very careful about other people. There has been a lot of talk both before this hearing and during this hearing about whether individuals should have been charged.

I would like to ask your opinion. You are a career prosecutor. Everybody here said that, even those questioning your judgment here in this case. You are a career prosecutor. You are the expert on this, and I would like to know what do you believe a prosecutor ethically is required to consider before indicting an individual?

Mr. **Murray**. Well, I think what that person has to do is take into consideration the collection of evidence that is against the individual, and we have to determine whether or not we can prove beyond a reasonable doubt that a person has in fact violated the law.

The person doesn't have to know the specific statute, but that a person acted intentionally and knowingly and that there is a Federal statute that has been violated. I think what a prosecutor has to also do is take into consideration all the facts and circumstances around the investigation which may mitigate on that person's behalf.

I also believe that we must deal with defendants in a compassionate manner; that while we should be very, very tough with individuals and companies or whatever, we must be fair. We must not be overzealous in our prosecution, and that sometime sour ego gets involved.

We have got to look at the actual facts dispassionately and make a determination which is from our heart, not necessarily also from the mind, based upon our experience, our trial experience, and we have got to also balance it with the need to benefit the people of the United States. I may sound wrong, but that is why I joined, to work for the people, and I have got to balance the overall interests of the people of this country, not just my own person.

Mr. **Lungren**. Mr. Murray, in light of that standard, in light of what you knew at the time, and what you know now, do you think you should have indicted individuals in the Hutton case.

Mr. **Murray**. No; if I had been in the middle district of Pennsylvania, and I know the inference is trying to be made that somehow the people in Washington tried to influence me, which they did not, OK, and if E.F. Hutton had offered to plead guilty to one count of any felony along with injunctive proceedings, I would have taken that bottom line. I would not have done a nolo. I wanted an admission of guilt, and what was important to me was injunctive proceedings, and I will defend that to my dying day whether or not an oversight committee wants to second guess my judgment or not. That is the way I feel.

Mr. **Lungren**. How long would pretrial and trial have taken in this case do you believe?

Mr. **Murray**. I think a trial of this case would have been a year and a half if the company had made us prove every single element of the crime, including all the transactions involving checks. As I will explain to you hopefully later, each check had approximately 20 pieces of proof that would have to be entered into evidence regarding that item. I think the pretrial discovery would have lasted 6 to 7 months.

I think the trial of the Government's case in direct would have lasted 6 to 7 months along with defense of E.F. Hutton would have taken approximately 6 to 8 months. I believe after that what would have occurred is that matters would have been appealed to the third circuit. The third circuit would probably have the case 8 months to 1 year. After that I think the matter would have been appealed to the Supreme Court of the United States where the matter would have been maybe 6 months there.

I calculated that approximately 1988, around there, maybe there would have been a disposition of the case. All along while the are of cash management may have well been in chaos.

Mr. LUNGREN. If you would have to estimate, what were the odds that you would have made it to trial if you had to try the case?

Mr. MURRAY. It is really hard to make an estimate, but I can only tell you this: My one fear—one of the major fears that I had was the testimony that I had before the grand jury, and I can't tell you what that was—that the bank victims, the bank's so-called victims in which this case was based upon, that I had to show that the bank was a victim, and that the Federal Reserve of the system was also a victim—would not specifically relate to the banks, were not attractive victims.

There was a love-hate relationship, and the banks would not admit that E.F. Hutton had defrauded them because E.F. Hutton was one of the major——

Mr. LUNGREN. What would you say the odds were that you would have convicted the company?

Mr. MURRAY. I think it would have been 50-50, and I will tell you something. Somebody said, "You have a tough case." If I had nothing, no plea agreement, I would have taken the case to trial, period, and I would have just tried my best and whatever the jury would have done.

Mr. HUGHES. Fifty-fifty maybe?

Mr. MURRAY. It is hard to make an estimate. I will tell you this. I saw some paper by Mr. Safire, who said we shouldn't avoid, we are paid to do trials. I would have worked this case until I died, I will tell you that, so I would have gone—the time, the effort, I didn't care about that, because Hutton tried to push me around. I would have tried this case to the death.

Mr. HUGHES. If you would have obtained——

Mr. MURRAY. The blood and——

Mr. HUGHES. If you would have obtained a conviction against the corporation, would you have been able to get the injunctive relief——

Mr. MURRAY. No.

Mr. HUGHES [continuing]. That you obtained in your plea agreement?

Mr. MURRAY. No, absolutely not. Not only that, though the counts would have been minimum. I would have been able to charge a conspiracy United State Code 371 with overt acts occurring across the country. Hopefully, I can explain that.

That would have been one count. That would have been in essence supportive of the various substantive counts. Generally, we have a rule in the middle district of Pennsylvania only charging like 20 to 33 counts. I think possibly I could have argued to the court that that should have been relaxed because of the magnitude of the scheme and would have charged maybe possibly 100 wire fraud counts. Wire fraud and mail fraud carry with it a $1,000 fine. A hundred times 1,000 is what? $10,000, $100,000, possibly.

What I think would have happened if the case would have been indicted without pleas if the company would have come in and done what they tried to do analogous in the T.I. case and tried to plead nolo contendre. They would have tried to argue to the court that a nolo contendre plea, meaning they would neither admit nor deny, would be necessary to protect their investigators because what would happen when Hutton pled to one felony count they put their entire license into jeopardy, whether or not the SEC wants to revoke it or not.

That is not my business. The bottom line is that a nolo contendre plea they would have argued that that nolo contendre plea would not be able to use against those regulatory agencies and therefore it would not have jeopardized their license.

What they were afraid of during the entire case was pleading to a felony. They did not want to plead to a fraud because fraud sounded bad, it was common law mala mens.

Mr. Hughes. The Chair recognizes the gentleman from Kentucky.

Mr. Mazzoli. Thank you, Mr. Chairman.

Once again I salute you, Mr. Murray. It has been a long, tough day and you have handled yourself admirably.

Mr. Murray. Truthfully.

Mr. Mazzoli. Probably if you had known what you were getting into, you may not have been willing to come in.

Let me get at a couple of things. One, our chairman said a moment ago about Monday morning quarterbacking, and it does seem to me that that is precisely what we have perhaps unwittingly gotten into in today's questions, trying to second-guess your prosecutorial judgment, which occurred years ago, following quite a significant and very well documented effort on your part to analyze mountains of information, and to have done so with a quiet severe respect for the reputations and for the feelings of the people involved.

It seems to me that our inquiry should not be whether you should have prosecuted this individual, that individual, those 10 people, because I personally have a feeling, which I have said many times I think Fomon did have some responsibility here. You may not, and I salute you for it, but I still think that that kind of activity could not have gone unnoticed in the boardroom when the good performance of some obscure little office in Sioux Falls, SD, would receive kudos.

Mr. Murray. I agree with you. I just let you know I agree with you.

Mr. Mazzoli. So it is not whether you should have prosecuted him, pilloried him, drawn and quartered this idividual or those individuals. The question is as a seasoned, experienced responsible prosecutor, you tell us, I would ask you one more time for the record, based on what you know today, what you knew then, do you feel the correct, responsible, proper thing was done to represent the people of the United States which is your charge?

Mr. Murray. Yes, I do.

Mr. MAZZOLI. Let me ask you this. We should not second-guess that judgment. We might, if we were in your spot, choose to do a different thing. We could have had a full fledged this or that investigation, charges, but I think what we could inquire about, and should inquire about, was whether or not this judgment was reached not independently, not based on your experience, not based on your academic credentials, your integrity as a man, as an attorney, but whether or not it was reached because the gentleman to your left leaned on you, because the gentleman, his superior, leaned on him, who then leaned on you, then leaned on somebody else.

So the question that I guess I would like to ask is, once again for the record, was this judgment, which I might quarrel with, and I will tell you the reason why I might at least in slight part, was this judgment on your part reached as a result of any interference, any—and let me explain it this way—blatant, overt influence, or there is a subtle kind of influence which we in the bureaucracy are very well aware of. Was there either overt, blatant or quiet sort of——

Mr. MURRAY. Intimidation, subtle intimidation?

Mr. MAZZOLI [continuing]. Nuances which a very intelligent man like yourself will quickly pick up?

Mr. MURRAY. Thank you.

Mr. MAZZOLI [continuing]. To indicate a kind of subtle influence? Was there either overt or subtle influence in this case?

Mr. MURRAY. I can state in the presence of you and God and my belief, no, none whatsoever, from no one.

Mr. MAZZOLI. Thank you.

The last thing I would like to inquire about today is this, because I thought your opening statement was I thought excellently prepared, and it was full of small quotes which I took, short lines, which I think display the case, and you talked about the double standard, the concern you have about the double standard, and it was interesting.

Some of our hearings have been carried by C-SPAN to the hinterlands in the country, where people that I represent and others live and function, and I for one have received letters and comments from those people, saying that, you know what, Mr. Mazzoli, if I tried to float——

Mr. MURRAY. That is right.

Mr. MAZZOLI [continuing]. A $10 bad check, if I don't have money in the bank to cover a $20 bad check, what happens? They come and want to throw me in the slammer and throw the key away. What happens when these guys float not hundreds, not thousands, not millions but maybe over the long haul billions of dollars sloshing around, which cannot be at that moment redeemed, what do they do? They don't do anything to them.

So let me ask you my last question. In view of the double standard, the need not to let Mr. Joe Lunchbucket feel like this guy on Wall Street gets away with murder when he is going to be put away, does this decision which you reached freely and which your superiors endorsed, does it somehow destroy the double standard?

Mr. MURRAY. I believe that is what it does, it exposes the double standard that exists, and that it does, that the legislation should now actually destroy that double standard, because what I found is that the double standard is alive and well in this country, because there is a very tight partnership between corporate America and the banking institution, and forgive me, bankers, but that is the way it is. What it is they are interested in the bottom line, competition and money.

One of the reasons why the banks don't, some of the banks don't even know about this scheme is because all they care about was the bottom line on the dollar. Corporations are allowed to take availability. I don't want to get too technical, but they pass back Federal provisional credits. The Federal Reserve, the people of this country, are supporting that passback credit to the banks.

So when the companies of the world start to deposit those funds and do schemes, a practice which I am now saying is a scheme as of May 2, they are now condoning and passing it on to the people, and Al Murray can't write a check and my banker will come to me and say, "Hey, Al." But the corporate method is different. They can.

Mr. Mazzoli. It is kind of interesting, Mr. Murray. I think that your experience is mine. Many times the so-called simple people are a lot more wise and have deeper insight than sometimes the most well trained and highly educated people.

Mr. Murray. That is right.

Mr. Mazzoli. And sometimes these people who have communicated with me about television that they watch have said: You know, it is funny, all of this Rube Goldberg lines, just like your maps, in and out, in and out, and sometimes they get away with that when I am simple and little, and they crush me down.

So you believe, though, that you have, first of all, exposed the double standard?

Mr. Murray. That is right.

Mr. Mazzoli. And accommodated to it to the extent that you can through injunctive relief and fines and what have you, leaving the balance of the task, as it should be——

Mr. Murray. To Congress.

Mr. Mazzoli [continuing]. To the legislative——

Mr. Murray. That is right.

Mr. Mazzoli [continuing]. To decide whether or not there should be changes.

My friend from Connecticut was mentioning that there is a bill I think that has been reported by his committee, which in part could be a response to the other side.

Mr. Murray. That is exactly my feeling. That is exactly my feeling.

Mr. Mazzoli. The chairman is about to pull my string, but let me just say one thing. Early on in these hearings, in addition to saying I think that Mr. Fomon and some of the people in Wall Street here are very much responsible, I have also said that I think underlying a lot of this is the game the corporations are forced to play to beat the game the bank is playing on them, which suggests, furthermore, as you have also said, that the banks are wittingly or unwittingly, because in some cases they are acting as accomplices to this swindle.

Mr. Murray. Exactly right.

Mr. MAZZOLI. In some cases——

Mr. MURRAY. That is right.

Mr. MAZZOLI [continuing]. Their very tough tactics force this swindle to take place?

Mr. MURRAY. That is exactly right.

Mr. MAZZOLI. But they of course are not without blame and their hands are not clean——

Mr. MURRAY. That is right.

Mr. MAZZOLI [continuing]. In this whole activity.

Mr. MURRAY. May I make this one comment. When we talk about responsible, I think the Bob Fomons of the world, that he wasn't doing anything more than what some of his other peers were doing. I think his responsibility is to—I think it was negligent in his management.

I think the industry practice, OK, is now that bad activity has now become the rule, so that the morals and the ethics of the whole industry is askew, so that you can't pin criminal liability because under mail fraud you have got to look at industry practices and say is it deviation from industry practice. And the practice is faulty, so if you do that, when he says, you know, he doesn't have a criminal responsibility. The industry has a responsibility.

Mr. MAZZOLI. Right.

Mr. MURRAY. The theory is beat the banks, and what happens? The corporations are doing like this. They have got their hand around their banker with the other hand in the banker's pocket. I mean, that is the situation.

Mr. MAZZOLI. I have been dismayed through the entirety of these hearings which I salute the chairman for having conducted, but I have been dismayed throughout at the abysmal lack of ethics on the part of some of the people who, you know, where Gucci and Poochie smell of cologne, and yet in some cases they have got habits which people in the street would reject. Anyway, I thank the chairman.

Mr. HUGHES. The chair recognizes the gentleman from Pennsylvania for 5 minutes.

Mr. GEKAS. Thank you, Mr. Chairman.

I, too, in line with what Congressman Mazzoli was saying, am concerned about the view of all of this through and by the American public.

Mr. MURRAY. Yes.

Mr. GEKAS. And of course, all of us have been bombarded by the perennial question. Here it is, these giant corporate people, who were in effect slapped on the wrist and they are not in jail, and so forth. Why were they permitted to go into this plea bargaining thing rather than prosecuted to the fullest extent of the law. It is a very difficult thing for us. I am a former prosecutor.

Many of us are former prosecutors. We have all had to indulge in plea bargaining for a great number of salutary and proper reasons, and I think that is the background of my question, because I myself have been party to plea bargains, sometimes reluctantly, because of circumstances, sometimes fervently, in order to complete a case.

The basis of my question is how do you explain to the American people, to our constituents, to all people who raise that question, in view of the fact that this was, almost on every premise, a case of a first impression?

Mr. **Murray**. I think your last comment is really the answer, is that it was a case of first impression. It was involving novel issues. We don't indict people by virtue of them being a president or chairman of the board. We indict people because they have criminal intent to commit a crime, and when the crime itself is not defined, or the practice itself is not defined, we can't impute criminal liability to that person.

Unfortunately, Representative Gekas, you can't do it. If the collective intent of that corporation, all of those 17,000 people are acting without criminal intent, but the corporation actually commits a crime and the corporation is responsible. There are situations where there are valid corporate pleas. The identity of Hutton is tarnished. The individual cashier who takes out $9 million and knows in fact that there is 400 being deposited does not have the criminal intent to commit a crime, because they are following policy and guidelines.

The bottom line is when the industry practice, the guidelines that are started by the people up top, when they are looking to the industry to set the standard and policies for those other people, when that industry sets a standard that in and of itself is the practice which becomes fraudulent, you can't say that those people knew they were committing a crime. It is hard to tell the average person that Hutton stole all this money from the banks, and therefore nobody went to jail. But the bottom line is this money management practice was not even a crime until May 2, 1985.

Mr. **Gekas**. And that is an excellent answer, and that leaves me with only one follow-up concluding question. After all is said and done, do you feel, professionally, philosophically, viscerally satisfied that you did the right thing, that the plea bargaining was in the best interests of all concerns, and that justice was done?

Mr. **Murray**. Yes, yes. Not only was justice done, I think in essence the United States got more than probably what we were entitled to in this situation. I think Hutton—some people say, "Why the heck if you think, Al, if the case was so difficult, why did Hutton plead guilty?" I think a lot of that was a business decision on their part, and a lot of it was a matter of tough prosecution that we decided, not patting ourselves on the back, but we just said: We are going to take you to trial if you don't enter into this arrangement with us; we are going to indict you. And that is the way it is going to be.

Because we think that this activity is such that if we don't have a disposition, if you are not admitting to your guilt, then we think it is important enough to try to prove your guilt. Even if it means going to trial for 10 years we will do it.

But when they conceded to our demands, and demands that we felt that would set precedent, it was important then to pull your ego away from it and say this is in the best interests of the country. That is the bottom line. That is what we did.

Mr. **Gekas**. I have no further questions.

Mr. **Hughes**. The Chair recognizes the gentleman from Connecticut for 5 minutes.

Mr. **Morrison**. Thank you, Mr. Chairman.

Mr. Murray, I would like to shift gears a little bit, and get back into some of the specifics. One of the things that confuses me most is the urgency questions about protecting the people versus succeeding and prosecuting people, and throughout this discussion, you have kind of set those off as competing concerns, and your preeminent concern was protecting the people of the country, and we ought not let individual prosecutions get in the way of that, and I understand that.

I think balance might be struck in different places at different times, but when in your investigation, starting in 1982, did you conclude that it was a violation of Federal law to engage in this kind of a scheme?

Mr. MURRAY. You mean to engage in these types of practices? I believe that these practices, aggressive cash money management, a euphemism that this company uses, that I could develop that into a scheme to defraud, based upon certain facts and representations relating to the checking account and all.

What happened, I developed, we developed—not I—but John Holland and I developed four or five—I am glad you brought that up—four or five different types of what we considered practices which could be schemes.

Mr. MORRISON. I don't want to spend my 5 minutes doing that.

Mr. MURRAY. I'm sorry.

Mr. MORRISON. Because we have spent a lot of time getting to an understanding of those. My point is when, after you started this in 1982, did you believe you had violations of Federal law? In other words, when you first got this case, you said, "I don't know what we are doing here. We don't know what Hutton is doing. I want to look into it."

Mr. MURRAY. Right.

Mr. MORRISON. I am asking you when in your mind you concluded you had mail and wire fraud behavior that was a violation of Federal law?

Mr. MURRAY. That was a violation and was provable.

Mr. MORRISON. I don't want to know about crime. I want to know that you believed this was in violation of the standards set in Federal law for mail and wire fraud.

Mr. MURRAY. January-February. It was an evolution.

Mr. MORRISON. January-February of what year?

Mr. MURRAY. 1985.

Mr. MORRISON. Of 1985? In other words, you didn't believe that——

Mr. MURRAY. In November, I believed that since I had nothing, I had zero, that what I would be able to do is devise an indictment, if the grand jury expired—I am going to tell you——

Mr. MORRISON. I am going to stop you. Hang on. I am going to decide. We don't have a lot of time. It seems to me that at a much earlier time, and from everything that you have said, you have suggested that these are practices you wanted to stop, that the banking system was corrupt, that this whole thing was threatening the banking system, this is a terrible problem for the country that we had this cash management game going on out there. You didn't decide that in March 1985 or February 1985. You decided that much earlier?

Mr. **Murray**. No. You have to realize the ultimate indictment was an evolution—excuse me. I am just going to tell you the answer is that ultimate indictment was an evolution from various practices which I had, some of which I had determined. One, it was the kind of—I thought that was a possible scheme. Second, it was a draw-down scheme and the operation to recapture float. All of those evolved so that at the end of the case we ended up with two practices which we believed were provable and that was excessive overdrafting and the chaining, but before that, it evolved from six or seven other practices, if you have the time.

Mr. **Morrison**. You have a list of items which you also got a civil injunction?

Mr. **Murray**. Yes.

Mr. **Morrison**. Which you described as setting the standards for the industry.

Mr. **Murray**. Yes.

Mr. **Morrison**. And cleaning up this practice or at least making a first step at that.

Mr. **Murray**. Ultimately, yes, but—yes.

Mr. **Morrison**. That is fine.

Mr. **Murray**. Ultimately, that was all boiled down.

Mr. **Morrison**. I have several questions.

Mr. **Murray**. I'm sorry.

Mr. **Morrison**. Is it your current opinion that now or before May 2 this was a widespread practice beyond E.F. Hutton, these kind of cash management practices?

Mr. **Murray**. Yes.

Mr. **Morrison**. Then why in your memo in November——

Mr. **Murray**. I said that there was——

Mr. **Morrison**. No others.

Mr. **Murray**. No problem. What I said in my memo, that there were no others that were similar or whatever to E.F. Hutton, because what we had done is we had accepted the records only of E.F. Hutton and boiled it down to chaining, or drafting, et cetera, et cetera, et cetera. I did not have the records of any other corporation. What I did have though was the annual reports of various other corporations, and investigated the case, the caption checks and drafts payable created what I considered to be a float item which was similar to the checks—to the cash audit, checks and drafts paper of E.F. Hutton.

The specific chaining activity and excessive overdrafting activity was not similar to any other corporation's, but what happened is the overall cash management practice of generating and creating float was in fact common to the industry.

As a matter of fact, I am just going to tell you, as a matter of fact, Hutton's main point was that its practices were consistent with industry practice, and let me tell you what practices we are talking about.

Mr. **Morrison**. Don't do that.

Mr. **Murray**. But that is the——

Mr. **Morrison**. Hang on a second. Your concern, the haste, the need to wrap this up before 1988, the need to make whatever compromises were involved and the judgments of whether or not to go after individuals, whether or not to go on, was about protecting the public?

Mr. **Murray**. In November.

Mr. **Morrison**. And this isn't just about E.F. Hutton, so the question here, was your injunction only good against E.F. Hutton, right, so it doesn't go beyond that? My question is if this was the problem, why much earlier in this process was there no civil action taken for an injunction, which could have been preliminary in nature, could have been pursued much before 1985? Why was the decision made, if protecting the public was the key here, not to pursue this on the civil side?

Mr. **Murray**. You know why? Because if we had done this on the civil side, we would have had no criminal case. If we had done this on the civil side, we would have done all discovery on the grand jury investigation. If we had done this on——

Mr. **Morrison**. Go ahead.

Mr. **Murray** [continuing]. If we had done this on the civil side, it would not have had a criminal case. We wouldn't be sitting here today because when you do it on the civil side what happens is you have to do discovery of all the testimony, et cetera. We would have given all that. The possibility of a criminal case would have been impossible. It couldn't happen.

I will tell you the reason why we were so concerned is a letter dated November 16, 1981 that has been released by this committee. That was a letter from Vincent Pujot, Manufacturers' Hanover Trust Co. to E.F. Hutton. What it did, it said in the bottom paragraph of that letter is that bank was exposed, it is the fourth largest bank in the world, I think in the country.

To 1.018, et cetera, billion dollars, billion dollars on that date, and the bank didn't even know about it, well over the bank lending rate. That is Manufacturers' Hanover Trust Co. That scared me when a bank is exposed to that extent so long, and Continental Bank scared me because they were exposed and they were practically collapsing because half the banks in this country didn't know what was going on. That is what scared me, and E.F. Hutton was saying, "We are doing aggressive cash money management." That is what scared me. That is what I am talking about.

Mr. **Morrison**. It just seems to me that it is not exactly credible, that the problem we had to solve was to protect the system, and that our conclusion was whether or not we get a criminal conviction in the end is the key. If it is that much of a threat to the system, we should have started much earlier with the civil injunction in 1982.

Mr. **Murray**. Yes, but that is the message that you want to put out.

Mr. **Morrison**. But that isn't what you did, Mr. Murray. What you did is you played the whole thing out to the criminal——

Mr. **Murray**. Why are we here for that matter? If it was a civil disposition, that would have been the easy way out. That is what E.F. Hutton wanted. They wanted a civil disposition. They didn't want to be prosecuted criminally. We thought that what had to happen was not that the SEC ought to handle the matter. We thought it was a criminal prosecution plus a civil prosecution and that would be the message and I think that is the message of the

Attorney General and I speak for the Attorney General who said that the message was clear that this was to be handled now as a criminal matter. I could easily at any time say I don't feel like working anymore. I will send it to the civil side.

Mr. MORRISON. I can't help how you are organized as to where you have to end it.

Mr. MURRAY. I tried my best.

Mr. MORRISON. I don't know, Mr. Chairman, if I have more time.

Mr. HUGHES. Your time has about expired.

Mr. MURRAY. Then why don't you proceed.

Mr. HUGHES. Mr. Murray, in my first round, I think I had indicated to you my concern about some of the statements that were coming out of E.F. Hutton after the plea.

Mr. TROTT. Excuse me, Mr. Chairman. I think Mr. Murray would like a break. He has been under continuous cross-examination.

Mr. HUGHES. Why don't we take a recess. We want to finish because we are going to be—I know members have to leave shortly.

Let's take a recess for 10 minutes.

Mr. TROTT. Mr. Chairman, can you tell us for planning purposes how long you intend to go?

Mr. HUGHES. One more round.

Mr. MURRAY. Do you want me to explain all the charts and the actual system that was operating as fraud?

Mr. HUGHES. What we are going to try to do, Mr. Murray, is get to questions that members have.

Mr. MURRAY. I just want to explain for you.

Mr. HUGHES. It is very difficult. Why don't we just take a recess for 10 minutes. It is very difficult to try to develop any continuity in 5 minutes to begin with. We operate under quite a handicap, but let's take a recess and then go back and see if we can't get to the members. The members have some additional questions.

Mr. MURRAY. Thank you very much.

[Brief recess.]

Mr. HUGHES. The subcommittee will come to order.

Al, you had indicated in your testimony at different points that there was an evolutionary process.

Mr. MURRAY. Yes, sir.

Mr. HUGHES. A number of draft indictments were prepared over this period of time. In fact, I think as early as 19—mid-1984 when you first went to brief Justice on the case, you went there with a——

Mr. MURRAY. Yes.

Mr. HUGHES [continuing]. Almost 600-page draft indictment which you referred to.

Mr. MURRAY. The first——

Mr. HUGHES. At least in one of the memoranda that we have.

Mr. MURRAY. No, I think the first time I went to Justice I went with grand jury charts, evidence which I believe had constituted what I thought we would be able to prove.

Subsequently at another time——

Mr. HUGHES. In June.

Mr. MURRAY. In June, right, the first meeting with the Department, I did a chart presentation.

Mr. HUGHES. Then you traveled to Washington and at that time, you had a—in June I believe, early June 1984.

Mr. MURRAY. Yes.

Mr. HUGHES. At that time you had a draft indictment.

Mr. MURRAY. Yes.

Mr. HUGHES. And on November, in November the evolution was under way and another draft indictment was in the works preparing for submission to the grand jury that following week, in November 1984.

Then I presume in 1985 again, draft indictments were being prepared, notice had been given to the attorneys, deadlines, insofar as their submissions.

Mr. MURRAY. Yes.

Mr. HUGHES. And draft indictments were being prepared to take to the grand jury. I presume that included individuals as well as the corporation?

Mr. MURRAY. Concerning the evolutionary process, yes, because Mr. Trott had given us authority to go ahead with the individual and corporate. The first draft indictments were designated indictments, but I want to be completely frank with you, they were my working documents that I used to put together all the various conduct of the company and all the subjects, and possible targets.

That was not an indictment that I would have returned. That was my working product, and to be completely strategic about it and I guess I can say this because I don't think it is unethical or anything, I used that document to try to scare E.F. Hutton and their attorneys into believing.

I tried to make them a believer. In other words, I prepared that as a working document for me, for the postal people and to——

Mr. HUGHES. Besides that, you were getting ready for a grand jury.

Mr. MURRAY. No, I had already been involved in the grand jury.

Mr. HUGHES. Getting the indictment prepared to take to the grand jury if in the end your plea fell through.

Mr. MURRAY. That was not the original—that was not the original 650-page document that was prepared. The document that was prepared in November was the document—a document that was never—came out of our computer. That was what we were working on.

Then there was another document——

Mr. HUGHES. Mr. Holland, in his report——

Mr. MURRAY. Sure.

Mr. HUGHES [continuing]. In January, referring to the 11th, November 11 working session, that weekend, referred to the indictment as a final draft indictment.

Mr. MURRAY. We were preparing one. It was never completed.

Mr. HUGHES. That was being prepared for submission to the grand jury, I would presume.

Mr. MURRAY. Oh, yes, yes it was, but it was never completed.

Mr. HUGHES. I understand. But my question was it was being prepared for submission to the grand jury.

Mr. MURRAY. Yes.

Mr. HUGHES. Isn't that why we prepare indictments generally?

Mr. MURRAY. No, I say, I prepared the original——

Mr. HUGHES. Generally speaking don't we prepare indictments to submit before the grand jury?

Mr. MURRAY. Well, overall, if they are going to—that is an accusatory instrument. They will eventually charge the crime within it. It has to be sure. But a lot of times I prepare it just to give myself a working model to follow.

But eventually——

Mr. HUGHES. I handled grand jury for 10 years, and I never prepared indictments to take to the grand jury unless I was going to take them to the jury or decided in the interim to take what you call an information, proceed on that basis.

If the negotiations take place and you accept the lesser plea or change the direction of the trial, the point is, you were preparing indictments. You may have had other reasons to prepare indictments to send a notice, a signal to E.F. Hutton that you were serious about this, and they better get on the stick, but you were also preparing indictments during this evolutionary process for commission to the grand jury.

Mr. MURRAY. That is correct, but yes, it is not fully correct because in the Federal system sometimes, what there is you prepare an indictment for review by fellow attorneys and you prepare it as a draft for your fellow attorneys to go over, and also you prepare——

Mr. HUGHES. But, yes, that is another reason.

Mr. MURRAY. But that document is not the final document nor are the people or individuals or corporations mentioned in that the final draft.

Mr. HUGHES. What theories along the way——

Mr. MURRAY. Yes, sir.

Mr. HUGHES [continuing]. Did you scrap? There was apparently one theory in November and another theory in——

Mr. MURRAY. Yes.

Mr. HUGHES [continuing]. In January, another theory later. We know as late as March 4 you were proceeding on the theory that you would go after individuals and the corporation. March 4, we know that from correspondence.

Mr. MURRAY. Sure.

Mr. HUGHES. A proffer was being made regardless of the, of whether the corporation accepted a plea, accepted the proffer of a plea for the corporation.

Mr. MURRAY. That never happened.

Mr. HUGHES. I realize that. But I say you were preparing in any eventuality to move ahead with corporate targets, as well as individual targets.

Mr. MURRAY. Yes.

Mr. HUGHES. Regardless of whether the plea by the corporation was accepted.

Mr. MURRAY. If the plea of the corporation was accepted pursuant to—I wrote a letter, I wrote a letter to the Department——

Mr. HUGHES. Let me read this letter to you.

Mr. MURRAY. I was going to be responding. That was the letter I sent to the Department outlining what I believe to be a skeleton, a skeletal agreement where it says we are talking about corporation only, and then later on we will proffer the individuals. That is what I did. I wrote a letter outlining what I believed to be the parameters of the plea agreement. I believe what it said was we would offer the corporation first and this related to the corporate defendant only, and that subsequent to that we would make proffers to individuals.

That is what I said in the letter. I believe.

Mr. Hughes. Let me read it to you because it doesn't quite say that. It says, "As we have previously discussed, we will proffer individual targets subsequent to the corporation's acceptance or nonacceptance of these basics."

Mr. Murray. That is the letter.

Mr. Hughes. Most of these items have been discussed with Tom Curnin who agreed in concept but of course, his major commitment is desiring civil disposition—which you have said repeatedly.

You go on to say, "I will recalculate the remonetary benefit of Hutton's scheme and suggest we mention no total definite restitution amount until determined. This sum may range from $15 million to $250 million, depending on how we prepare and present the calculation."

Mr. Murray. That is correct.

Mr. Hughes. Well, my question is during this evolutionary process——

Mr. Murray. Yes, sir.

Mr. Hughes [continuing]. How did your approach, your strategy, change?

Mr. Murray. OK.

Mr. Hughes. You must have dropped some theories and adopted other theories. We know, for instance, that at some point you decided to go after the operations.

Mr. Murray. Yes.

Mr. Mazzoli. Could I ask a question.

Mr. Hughes. Go ahead.

Mr. Mazzoli. Maybe I am wrong here, but isn't it the purpose of our hearings to establish whether or not these changes occurred because of outside influence? Because if we are not to quarterback this decision made on the part of Mr. Murray, we have got to show that somehow undue pressure, subtle, overt, whatever, was brought to bear on him and he was told to lay off, put your dogs in chains because we got friends in high places.

If that isn't the case, then whether or not the theory evolves and changes, whether or not you try four or five different combinations, whether you write drafts and I write my office drafts of everything I send out 12 different times, that to me is not germane unless there is——

Mr. Hughes. I quite disagree with the gentleman. I think it is germane because one of the principal issues here is as to whether or not the defendants' individuals should have been charged and how that changed.

Mr. Mazzoli. Except I——

Mr. Hughes. That bears on the question of the handling of the matter.

Mr. Mazzoli. Prosecutorial discretion. I didn't think Mr. Murray was here to defend his judgment.

Mr. HUGHES. Nobody questions his judgment at this point. We are trying to find out what evolution took place. I think the gentleman can answer the question. The gentleman can answer the question.

Mr. MURRAY. I believe the question is what——

Mr. HUGHES. What theories were dropped, which were adopted. We end up at some point with a theory we should go after the overdrafting, for one thing.

Mr. MURRAY. Forgive me for my explaining this. The first time John and I looked at this, we had what I believed to be eventually four or five different practices that possibly could result in cash management abuses.

One was what we call the Manie-Hanie flip-flop involving daylight overdraft with Manufacturers Hanover Trust and Chemical Bank. That was what I determined to be a pure and simple check kiting. Period.

Second, what we had was abuse of the overdrafting—excuse me, of drawing against uncollected funds in the lower level within the inter-branch transfer network.

Third, what we had was what we believed to be what is called a SAIK offset or offset accounts, arrangements where a commodity and trust accounts are set up and then offset accounts or checking accounts are being maintained to offset the profit in the other account.

We had a—we had a fourth premise and that was that the worksheet that we have heard about so much in and of itself constituted possibly a scheme to defraud in that it dealt with anticipated deposits in a way, coupled with multiple algorithmic changes, and what it did was in fact, create float rather than what the company was saying was recapturing float.

Ultimately what we had to do, what I did is boiled down the theories to one that a jury might possibly be able to grasp more readily. I, therefore, decided along with Peter and Bob and John, that what we would do is take the Manie-Hanie flip-flop or the kiting, that is what we called it, the company called it facilitating transactions, I said you can use whatever corporate euphemism you want, it is a check-kite plan and simple except possibly we couldn't prove it because Manufacturers Hanover Trust allowed it to go on for years and years.

We said that may not be a totally provable scheme and therefore what we would do is, we want to stop the practice, we would therefore go to injunctive proceedings. Concerning the SAIK offset account relationship without getting into the boring details of it, I believed from the beginning that the SAIK offset that involved 11 banks, United States Trust Co., Morgan Guaranty and some larger major money center banks in the country, that that in fact operated in essence as a pure and simple check kite. However, what we learned was that that was not a prosecutable one. The reason why it was not prosecutable is that the United States Trust Co., Morgan Guaranty, Citybank, et cetera, Chemical Bank, set the system up, they set it up for Hutton to fully do this activity.

It is a very complicated procedure, but what it is it is like an attorney's escrow account, you cannot touch that and what happens is a form of I think some type of financial extortion but what

Hutton does is says, I can't touch these funds but what I want to do is monetize the use of that fund in that bank and offset the bank's profit.

What it does is exposes the bank to a risk of loss that cuts down the ultimate profit margin.

Mr. HUGHES. Can you now just relate that theory and the changes, how they found their way into the draft indictments and how they evolved.

Mr. MURRAY. OK, we believed that that activity, while it technically was a kiting of checks in the manner in which it was manipulated could not be proven because the banks approved it and set it up. We looked at the third system and that was the drawing against uncollected funds in the region.

We then developed a theory that the zero balance account which is a controlled disbursement technique was in fact a credit extension or part of a credit facility of the company; that therefore was used to support the overdrafts that were created on the books of Hutton, in the books of Hutton and its corporate records.

We felt that that was a prosecutable crime because of the fact that in financial circles a demand deposit account is used for receipt and transfer of funds mainly. It is not to be used as an interest-bearing account.

That if in fact it was being used to create moneys or interest bearing accounts, it was a use being misrepresented to the bank and therefore, a deviation of business practices whether the banks recognized it or not.

The effect of the zero balance account on one bank affected other banks who may have not had knowledge, because the concentration system in Manufactures Hanover Trust Co. is connected to the disbursement system of BOA, connected to other banks.

So we said that that was now going to be the basis for our premise of the scheme to defraud.

When Hutton was saying that we use the zero balance accounts for disbursement purposes, we said no you are not, you are using it to create float and to supplement—excuse me, Mr. Chairman—so we said that that is a viable theory. Then what we did, we said the drawdown sheet, however, I believe the drawdown sheet in and of itself is fraudulent conduct. Period. I believe recapturing float without the bank's knowledge can constitute a scheme to defraud. Period.

The codification of that sheet, I say it was almost a per se crime. However, we could not specifically charge that, we thought it was too hard to charge. The operation of the sheet.

Two reasons; even though Hutton—I don't care what they say about it, they say it is a codification of corporate policy. It was not because the branches and regions were not able to uniformly use it. It was discretionary. To prove that recapturing float in and of itself was inherently wrong was going against industry practice, and therefore to charge the drawdown sheet per se in an indictment would not have been done.

Mr. HUGHES. You found the drawdown sheet was not unusual?

Mr. MURRAY. A drawdown sheet was not unusual.

Mr. HUGHES. Not as a business practice?

Mr. MURRAY. No.

Mr. HUGHES. Did you find any practices similar to the excessive overdrafting done by E.F. Hutton?

Mr. MURRAY. You are bringing me to the main point which I should, I want to—you want me to answer. We felt the most attractive case that could be made and prosecuted was the excessive overdrafting. Let me give you the definition of excessive.

Excessive overdrafting, syllogistically overdrafting per se, the premise is not necessarily in and of itself inherently criminal, because there are about four or five different methods of overdrafting. So what we decided to do was use, quantitatively set a speed limit as to what we considered to be excessive overdrafting. Quantitatively it could be any amount of money that is over and above the actual economic transaction or benefit that the company's involved in.

So an excessive overdraft as far as I am concerned, could be $6 if your economic benefit was only $5.

Now, whether or not you want to use that as the standard or you want to use $9 million based on $400 million as far as I was concerned, that is still an excessive overdrafting. A dollar in and a dollar out, that is what you are supposed to take out of the system. The recapture float, every time float is created in the system, you create cash.

Our belief was, is that by virtue of the company now manipulating that system so that the banks were paying, the company in essence that was in fact, could be prosecutable using the most egregious examples, but that egregious example was an outflow of the whole system designed to create float.

So whether you create $1 or $1 million of float, is still creation of float. Therefore, what we would do for purposes of the plea agreement and for criminal indictment if we had not gotten the plea agreement would use the United Virginia Bank example.

Mr. HUGHES. Which is the most egregious of the examples.

Mr. MURRAY. Yes.

Mr. HUGHES. Let me just if I might, because time is really very short. Let me if I might, in your letter to Peter Clark you refer to the range of restitution being anywhere from $15 million to $250 million.

Mr. MURRAY. Yes.

Mr. HUGHES. What in your judgment was the extent of the fraud perpetrated by E.F. Hutton?

Mr. MURRAY. Wow.

Mr. HUGHES. On the various victims. I am talking about the Federal Reserve System.

Mr. MURRAY. Yes.

Mr. HUGHES. They would be a victim. Which means the American people would be a victim.

Mr. MURRAY. Yes. Definitely.

Mr. HUGHES. That means the banks would be victims.

Mr. MURRAY. Yes.

Mr. HUGHES. That means that—so we have a number of victims.

Mr. MURRAY. Yes.

Mr. HUGHES. To what extent did you—you probably are as close to the case as anyone. What in your estimate is a fair estimate of the amount that was made as a result of the fraud?

Mr. **Murray**. I really cannot give it to you. One reason why is because you can't get the books—Hutton's books and records are not available for 1977, 1978, et cetera. They do not break out the interest that is made and the dollars made on the overdrafting.

Mr. **Hughes**. Is it fair to assume it could be anywhere between 15 and 250 million?

Mr. **Murray**. Depending, I am not an accountant, but whoever the accountant is, you can calculate 15,000 ways and come up with one figure.

Mr. **Hughes**. You thought 15 to 250 was a pretty good——

Mr. **Murray**. Big wide gap, yes. I thought that was conceivably based on the various schemes, not just excessive overdrafting.

Mr. **Hughes**. Would it be safe to say it is unlikely to be less than 15 million?

Mr. **Murray**. Unlikely it was less than 15?

Mr. **Hughes**. Interest rates were anywhere between 16 and 20 percent.

Mr. **Murray**. It would be unlikely but the only problem we had that with that, proving a specific dollar amount, is that the banks calculated their profit on a global approach. What they would do is collectively and aggregate all the Hutton accounts so that if E.F. Hutton, for instance, went negative on one account and the bank suffered a loss on one account, they might be positive on another account and what they would do, the banks would net that against one another and may have an overall profit.

Let me just tell you one thing. The Federal Reserve, we went to the Federal Reserve prior to the entry of the plea. We ran through with—I and John and Peter went through with the Federal Reserve people all the injunction proceedings. I asked them at that time is it possible that you as the Federal Reserve can calculate the value of potential fraud regarding this. I don't want to embarrass the Federal Reserve—regarding the check clearing process.

They said, Hutton doesn't know this but they said no, they could not. The reason why they could not is because fortunately, we had the Monetary Control Act of 1980 and 1983 the pricing controls. Prior to 1983 the Federal Reserve could not determine the source of the $6 billion a day Federal float that was being created. They could not identify it. So therefore what would happen ultimately in a trial with this disposition we could not give the Federal Reserve restitution because they couldn't calculate it.

Mr. **Hughes**. Is it safe to say at this point that all nine regional offices were involved to one degree or another in overdrafting?

Mr. **Murray**. Well, I want to be specific but it depends on how you, what you, how you define overdrafting. I can say this——

Mr. **Hughes**. After all that?

Mr. **Murray** [continuing]. Hutton created an environment to go after and create float and that all offices were very much aware of the creation of the float, even on a disbursement side, on the concentration side. All the nine regions were engaged in what I considered to be float-producing practices.

Yes. I also believe that the high muckity-mucks up top set the policy of creating float based upon industry practice. I said that to Judge Nealon on four or five occasions, I have always said it. If anybody in E.F. Hutton said they didn't understand the practice, they are wrong. The question is, not knowing the practice, knowing that ultimately criminal liability is whether or not they knew the practices were criminal, we developed that.

However, if anybody from Hutton says they didn't know about the drawdown practices, they are just misleading the committee and the American public.

Mr. **Hughes**. Wouldn't this type of case you would have to determine that from the circumstantial evidence that exists? For instance, one of the things that concern me is that E.F. Hutton was very careful about not referring to the drawdown system. They referred to it as the Morley system.

Mr. **Murray**. Right.

Mr. **Hughes**. We talked to Mr. Morley. He never described it.

My colleague from Kentucky, I think has put his finger on it a couple times. Here we have a scheme that involved all nine regional areas of the country in one way or another, over 100 branch banks involved, $1 billion zero balance account in New York, it required that they have checkbooks in the branches for their—to cover the overdrafts on a given day.

The chaining of—the chaining was something apparently that came in at a later time as they realized they could create more float by creating more banks.

Mr. **Murray**. That was overlapping, yes.

Mr. **Hughes**. That was all timing.

Mr. **Murray**. Right.

Mr. **Hughes**. They had to every day determine at the regional office and the various branches how much they needed to cover that particular day, or how much they could draw down on a given day.

Mr. **Murray**. Yes.

Mr. **Hughes**. They would move accounts out of New York to rural parts of Pennsylvania, to maximize their float.

Mr. **Murray**. Right.

Mr. **Hughes**. Do you think a branch manager would make those decisions?

Mr. **Murray**. Yes.

Mr. **Hughes**. To move——

Mr. **Murray**. I will tell you——

Mr. **Hughes** [continuing]. Not at headquarters? To move accounts out of New York and go to Pennsylvania?

Mr. **Murray**. Yes. I will explain to you why I have said to you, one zero balance account is not a $10 billion zero balance account. The zero balance account is secured by a credit facility and the checks are paid upon their clearing. So the zero balance account was basically a situation on the disbursement side where it had no value until the checks cleared.

Next, the situation is that the change resulted from the overall attitude of the company to create float within the banking system. Whether or not the practices themselves—the practices themselves didn't matter how it did it so long as it created the flow. The problem is that what you have is a decentralized company.

You have the regions and the branches that are setting policy all across the country.

Mr. **Hughes**. That was not my question, Mr. Murray.

Mr. **Murray**. I think it is a collection of——

Mr. **Hughes**. My question is: Here you have a $1 billion zero balance account.

Mr. **Murray**. Not a zero balance.

Mr. **Hughes**. The branch wouldn't set that up?

Mr. **Murray**. It is not a billion dollar zero balance account. The zero balance account has no value.

Mr. **Hughes**. It had an activity in it during a given month.

Mr. **Murray**. Yes; that is right.

Mr. **Hughes**. Of $1 billion.

Mr. **Murray**. It is not a $1 billion account.

Mr. **Hughes**. No, no, it is an account that has $1 billion in activity, the purpose of which was to cover overdrafts.

Mr. **Murray**. Well, no, the purpose—there were several purposes of that zero balance account. The purposes—there were three zero balance accounts: U.S. zero balance, BOA balance account, at one point a chemical balance, at another point there was an arrangement with mortgage guarantee of some type of account.

The purpose of the zero balance account was to create float on the disbursement side to cover customer checks and cover any unintentional overdrafts.

Mr. **Hughes**. Were there any checks drawn on the zero balance account used for things other than covering overdrafts?

Mr. **Murray**. Yes. The whole crux of our scheme which we brought here to the committee——

Mr. **Hughes**. Can you answer my question on that?

Mr. **Murray**. Excuse me.

Mr. **Hughes**. Can you answer my question?

Mr. **Murray**. What is that, sir?

Mr. **Hughes**. Were there any checks to your knowledge drawn on the zero balance account, any zero balance accounts used for other purposes than covering overdrafts?

Mr. **Murray**. Yes.

Mr. **Hughes**. Well, this committee has had a very difficult time determining that because we don't have access to those tickets.

Mr. **Murray**. What do you mean? You had—I don't—with all due respect——

Mr. **Hughes**. We have been trying for some time to get those documents to try to make that determination.

Mr. **Murray**. There are no documents—wait.

Mr. **Hughes**. Bank statements.

Mr. **Murray**. With all due respect, I don't think you understand the concept of zero balance accounting and what I am talking about because there are no documents that reflect that.

Mr. **Hughes**. No bank statements, checks, bank ledgers?

Mr. **Murray**. You have those.

Mr. **Hughes**. We don't have the bank ledgers.

Mr. **Murray**. I have talked to your committee people on——

Mr. **Hughes**. We have a gap of about 6 months.

Mr. **Murray**. Here is what you are referring to. You want to know how much—where were the zero balance accounts totals reflected on what books. That is what you refer to specifically.

Mr. **Hughes**. That is correct.

Mr. MURRAY. That is what you are referring to. But you also indicated the use of the zero balance account. I am not differing, I am saying for clarification there is a difference between the methodology as a controlled disbursement technique of zero balance accounts.

Mr. HUGHES. Aren't they records?

Mr. MURRAY. No.

Mr. HUGHES. You mean the bank ledgers are not records?

Mr. MURRAY. Bank ledgers will not tell you necessarily the volume or quantity of the use or the effect of a zero balance account. The zero balance account, it is a creature—it is a new creature. What it does is it is an overdraft account per se, so that every single time you write a zero balance account you create an overdraft.

What happens when it goes in the bank statement that will not reflect on the bank statement. What will happen is that the books of Hutton will reflect the use. That is where it will reflect. You have the books of Hutton. They have turned those over.

Mr. HUGHES. We do not have the books of Hutton on that particular period of time. That is what I am trying to point out to you. We do not have a——

Mr. MURRAY. No; but you do have some——

Mr. HUGHES. We don't have it for that period of time.

Mr. MURRAY. I don't want to differ with you, but I have talked to your staff about the use of the zero balance account.

Mr. HUGHES. I talked to the staff all the time and I have been trying to get those particular records for about 5 months.

Mr. MURRAY. I am going to tell you that I explained to your staff exactly where there—there is not any particular information on that. I don't think your staff really understood maybe what I was telling them because they were making faulty assumptions, with all due respect, believe me. But I don't think you understand the—maybe I can explain the use of the zero balance account and how they operated this scheme. That is what you want to get to.

That is the point that really needs to be answered. I think what you are making, the point is how can a company clear checks with a zero balance account or other disbursement of checks through a system to aggregate a total of $250 million per day to $4.34 million in 20 months, and not know of the use of the account? That is, I think, what you refer to.

Mr. HUGHES. That is the bottom line, that is right.

Mr. MURRAY. Thank you, that this is the bottom line. The bottom line is they in fact did know that. They distributed those zero balance accounts, checks, for one purpose, and that was to cover overdrafts in the account—in their books. The purpose of that was to create float and do interest profits. That is the crux of this case. That is why we are here, because we——

Mr. HUGHES. I couldn't agree with you more. That is the crux of the case.

Mr. MURRAY. We developed the operation of the scheme that was to defraud which we brought here based on that.

Mr. HUGHES. That points up what Mr. Mazzoli and myself and many others have said in response to the suggestions that those in senior management were not aware of these practices.

Mr. MURRAY. Yes.

Mr. HUGHES. And pointed to the fact that branches were off the reservation.

Mr. MURRAY. No, no.

OK when they—let me clarify. When they, Hutton, has said the branch is off the reservation, that was their first response to try to avoid corporate criminal liability.

Mr. HUGHES. They said that when they——

Mr. MURRAY. Excuse me.

Mr. HUGHES. They said it in this committee room.

Mr. MURRAY. I don't care whether they said it here or said it in public. The response to that is wrong; it is erroneous. The bottom line is that that corporation was aware of the practices to create float, and they wanted to generate float any way they could.

The question, though, was whether or not any of the officers that set up that atmosphere—whether they knew criminally whether or not they were responsible.

Mr. HUGHES. Once again, Mr. Murray—and this is my last question because my time is up, has been up—and that is to be gleaned from the circumstances——

Mr. MURRAY. Yes.

Mr. HUGHES. You seldom find a smoking gun, do you, where they say "I just stole $30,000"?

Mr. MURRAY. The Perry/Bacon memo was a smoking gun.

Mr. HUGHES. That surfaced afterward.

Mr. MURRAY. The Perry/Bacon—no, no. I had that document. I had that document before I entered into the plea agreement. I knew about that.

Mr. HUGHES. Didn't that surface in May of——

Mr. MURRAY. No, no, no, no.

Mr. HUGHES. April 1985?

Mr. MURRAY. That document broke the company's back, because what I had been doing is trying to prove to the company for years—John and I and Peter—yelling that that is what they did; and all of a sudden, prior to the agreement, here comes the Perry/Bacon memo, and I gave that to Mr. Trott, and Trott, as I understand, was running down the hallway to Bill Hundley saying, "We told you; we were right; here it is in the memo."

That memo was the entire case. And what it says is they have been engaged in that corporate practice over 5 years. And Mr. Bacon thought he was following corporate policy.

That is not a new document. We had that. That broke the company's back.

Mr. HUGHES. Was he granted immunity?

Mr. MURRAY. Oh, yes. Sure.

Mr. HUGHES. The gentleman from Florida.

Mr. MURRAY. The only way to get the testimony of Mr. Bacon to try to build the case against Bob Fomon and the higher-ups was to grant the people down below immunity. What you do to get higher-ups is cut the tree from the bottom. You start at the bottom and work your way up.

I wasn't trying to prosecute Perry Bacon. What I was trying to do is get Bob Fomon if there was criminal liability on his part. That is what I wanted. I wanted him and Lynch and all the people that may have set the scheme that deviated from industry policy and had the criminal intent to commit a crime. I wanted that. That is what we all wanted.

But the bottom line, when it comes down to it, is it just wasn't there.

Mr. HUGHES. I recognize the gentleman from Florida.

Mr. MCCOLLUM. Thank you, Mr. Chairman.

I think the witness has just demonstrated the tremendous effort he put into this case and how complex it was, and also, at the same time, the underpinnings of the decision that he ultimately recommended and went forward to make this settlement.

What he has just done is he has basically summarized the entire situation.

I want to ask something to clarify, Al, some implications made earlier in the testimony today, implications that at the time when Mr. Queen left as the U.S. attorney left his supervisory role of this case with you, that somehow by the exchange of the supervisory role to Washington to Mr. Ogren and Mr. Clark, that at that juncture you lost control or that somehow you had less control than you had before over the case.

Am I not correct that at all times in your position you have had a supervisor, and that that person is someone you are going to report to, make recommendations to, generally lets you run your cases but nonetheless has, if he wants to exercise it, some degree of control?

But you have told us today that at all times you really had the case. It was your case.

Mr. MURRAY. Yes.

Mr. MCCOLLUM. No matter whether the supervisor exercising the right of control was Mr. Queen or whether it was Mr. Ogren or Mr. Trott or whoever.

Am I not correct that at all times you had the same control over your case and it didn't differ when it went to Washington?

Mr. MURRAY. Didn't differ, no. Didn't differ at all. I had knowledge of the facts.

Mr. MCCOLLUM. OK.

And am I not right that in the bottom line that when the chips were down, the recommendations you made with respect to the disposition of this case were in the final decision day to make the settlement? Am I not correct that the supervisors then on the job, the ones from you—Mr. Trott and Mr. Ogren and everybody else involved—am I not right they basically accepted your recommendations to settle this case the way it was finally resolved?

Mr. MURRAY. Yes.

Mr. MCCOLLUM. Al, if you were to do it all over again, would you do anything differently?

Mr. MURRAY. Would I do anything differently? Well, what I do is try to represent the country the best way I could after reviewing all the evidence.

No, I wouldn't have done anything differently. I would have done it the same way. Although, I tell you, if you really want to know the truth———

Mr. SMITH. You would throw Mr. McGee out of your office the first time he came in; that is what you would do.

Mr. MURRAY. I am kind of—I am not a Democrat and I am not a Republican. I am a registered Independent. I have always been Independent. And I know you may not like this, but——

Mr. HUGHES. We like your independence.

Mr. MURRAY. Excuse me?

Mr. HUGHES. We like your independence.

Mr. MURRAY. So you can all be nice to me.

But I never thought I would be here. I thought what we were doing was the best thing for the country. I never realized that something so complicated as what we did would be misunderstood; that it would be distorted; that if I had—I took a chance. We took a chance. We kind of were idealistic. We did something we didn't—nobody else was doing.

Nobody was complaining of what we did. The criticism we have gotten, and on my reputation, I mean it appears as if I have personally been a part of something that was wrong, part of some kind of a scandal or cover-up or Huttongate or I was part of impropriety. But I know in my heart, and I know that none of that happened. That it was just hard, hard-nosed work. You all may differ with me but I know it is the honest-to-God truth that that is the way it is. The public may never know.

Mr. MCCOLLUM. Al, I think you demonstrated today beyond a shadow of a doubt that you are a man of high integrity; that you are a man who did what he thought at the time was in the best interests of his country, and I for one, based on what I have heard, believe you did exactly what was right. Some may differ as to details but I want to tell you that to any degree that your effectiveness and independence as a prosecutor is affected by this matter, I deeply regret that. I hope it has not been.

What you did and the manner in which you conducted this case is exemplary for anyone in the U.S. attorney's office anywhere in this country. I am proud of Al Murray.

Thank you, Mr. Chairman.

Mr. MURRAY. Thank you.

Mr. HUGHES. The Chair recognizes the gentleman from Florida.

Mr. TROTT. May I add one thing, Mr. Chairman?

That, Mr. McCollum, is the only reason I am here today. Not as Al Murray's counsel, but as a representative of the Department of Justice, so the world will know we stand behind our career people. When somebody puts on a superb performance the way Al Murray did, we back that performance no matter where Mr. Murray goes.

Mr. HUGHES. The Chair recognizes the gentleman from Florida.

Mr. SMITH. Thank you, Mr. Chairman.

I am going to speak for myself, Mr. Murray. I am happy you are here today. I have no intention, nor did I have before today, of criticizing your performance. Frankly, I think Mr. Trott's gratuitous remarks are the essence of the matter. It isn't a question of them standing behind you. Frankly, I am concerned they were trying to go around you. That is why we are here today.

Mr. MURRAY. Right.

Mr. SMITH. Al Murray isn't on trial here. We are not seeking to put Al Murray into a situation where the world says, "Oh, you didn't do right." I think every one of us on this committee from the very beginning has believed that you tackled an enormous job to some degree—I don't really agree with your characterization of novel, total first impression—to some degree——

Mr. MURRAY. I will explain to you——

Mr. SMITH [continuing]. Of a magnitude far beyond that which had ever been seen in these matters.

Mr. MURRAY. Right.

Mr. SMITH. So it is not a question of Al Murray at all. I want to make it perfectly clear from me, and I know your father is here and I don't know if that lady is your mother——

Mr. HUGHES. She is, yes.

Mr. SMITH. She is; she ought to be very proud like your father is. I know I would be proud. You are not here because we are seeking to determine whether you did wrong or to second-guess you. I think you ought to understand that right in advance, frankly. I do think, however, that there were concerns which were raised legitimately for us to look at in terms of the performance of the Department of Justice.

Mr. MURRAY. I agree.

Mr. SMITH. Separate and apart from what you at Harrisburg, all the people, Mr. Holland and postal inspectors, did with respect to this particular case.

Mr. MURRAY. We were together. But we were all together.

Mr. SMITH. You worked together but you were also separate.

Mr. MURRAY. No, no.

Mr. SMITH. Well, you may choose to look at it one way; I choose to look at it another way. That is the indiction. I look at the evidence, and I see certain things, not in the way you treat the case, but circumstantially, as the chairman has indicated, things, not with reference to Hutton but things with reference to the Department of Justice. So I am interested in finding out how I can close the gap between what I see——

Mr. MURRAY. OK.

Mr. SMITH [continuing]. And what I am being told. That is really for me the esence of why I am happy that you are here today

Mr. MURRAY. OK.

Mr. SMITH. First, I am a little bit, not surprised but a little bit disappointed that you would seek so strongly to keep making a point of industry practice. Mr. Mazzoli made the point, made it since the very beginning of these hearings, what is done in the corporate world apparently is much easier to get away with than it is on the individual level.

If Hutton draws up a rules and regulations manual which to some degree comports with industry practice but exceeds it enormously, apparently people who participate in that practice can be shielded from the "knowing and willing" portion of criminal intent because there was a manual.

If I went home tomorrow and laid out a business practice for my wife in terms of our budget at home, and I didn't write the check but I instructed her to write a $1,000 check on an account which had a balance of only $50, could she use my rules and regulations as a defense against a criminal charge of writing an overdraft?

Mr. MURRAY. No. 18, United States Code, section 2, allows me to charge you, you know, principal aiding and abetting, et cetera. The question is it is not the document that is communicated to the person as to whether or not it shields them from liability. The question is whether that person was actually with criminal intent to commit a crime and that they knew in fact was a crime.

Mr. **Smith**. Let me stop you there because I understand that is the definition under which you are working. We had testimony from a number of people who came in this room previously all employees of E.F. Hutton, they had checkbooks delivered to them, they had never seen or asked for. They had opened the accounts. They were then called on a day-to-day basis and told what checks to make out, which banks to deposit them in and the amounts of each check. They didn't know what they were for. They began to see their own profits increase and accrue, their own moneys begin to increase, their own take in this scheme.

Mr. **Murray**. Yes, I understand.

Mr. **Smith**. We had indications from some of the money managers, even Mr. Fomon said that it was a very competitive business.

Mr. **Murray**. Yes.

Mr. **Smith**. And that the scheme grew up, and that regions would go one against the other because of the competitiveness.

Mr. **Murray**. Yes.

Mr. **Smith**. Mr. Ball came and testified he was one of those rah-rah guys that tried to keep the spirit of competitiveness going, but when I asked them how come this spirit of competitiveness devolved into all the regions doing almost the same thing all the time, if it was so competitive how come the guy that invented this told everybody else exactly what he was doing, and everybody else copied the scheme in almost exactly the same fashion, using different banks, of course, but in a sense using a basically administratively alike technique all the way across.

Mr. **Murray**. Do you want me to answer that?

Mr. **Smith**. Let me finish.

Mr. **Murray**. All right.

Mr. **Smith**. They gave us answers which don't jell, which I don't think gave you any satisfaction and which didn't give us any satisfaction.

Mr. **Murray**. That is for sure.

Mr. **Smith**. You then concluded all that although there might be some criminal liability, you felt it was in the best interests of the government, of the people and the banks, et cetera to do and handle the case the way you did at the end. And I am curious as to the rationale for that which you have explained, in the sense that there were people directly lining their pockets as a result of this scheme.

Forget the corporate image, forget the stockholders benefit, forget a lot of things. There were people directly lining their pockets, making a lot of money, Mr. Bacon, among others, and it seems to me that the culpability there is so much apparent and so much evident that to just say that this whole case is well served by taking the plea and having a $2 million fine and an $8 million fund it leaves a little bit to be desired, especially in light of the fact as you just testified that you couldn't tell how much money had been generated in terms of illegal interest profits by virtue of this scheme. How did you arrive at the $8 million?

Mr. **Murray**. I will tell you

Mr. SMITH. OK.

Mr. MURRAY. All right. One, you are using, and I know you are an attorney, you are using a lot of terms, such as culpability, you are using the term scheme, and all that has meaning and it is being used a little bit out of context because it has got to be put in the context of the entire case.

The scheme was developed by us on May 2, 1985. Prior to this being called a scheme, which you now look back on——

Mr. SMITH. Prior to what date, I am sorry?

Mr. MURRAY [continuing]. Prior to May 2, 1985, it was industry practice. On May 2, 1985, when the public first became aware that it was a scheme that is when it became a scheme. That is one.

You say they are lining their pockets. Let me just explain. That is when they pled guilty.

Mr. SMITH. Can I ask you a question based on that alone? You keep raising points and I apologize if I interject.

Mr. MURRAY. That is OK.

Mr. SMITH. But you have to satisfy my curiosity.

Mr. MURRAY. I want to be very specific.

Mr. SMITH. In a memo by Mr. Holland dated June 26, 1984, there is a paragraph which has been submitted, this memo, by the Justice Department with some deletions, that there was a proposed indictment of 650 pages in length, which you used at a meeting between yourself, Mr. Queen and the staff of the AG's office in Washington, DC on June 25, the day before the memo was written.

[The document referred to follows:]

U.S. POSTAL SERVICE
INSPECTION SERVICE

REPORT OF POSTAL INSPECTOR

TYPE OF REPORT

☒ PRELIMINARY ☐ FINAL
☐ SPECIAL ☐ SUPPLEMENTAL

OFFICE: WILKES-BARRE, PA

ZIP CODE: 18701

DATE: June 26, 1984

CASE NUMBER: 115-8202318-F(2)

SUBJECT:
Check Kiting - Alleged Violator: E.F. Hutton
Court House Square, 212 N. River St.
TASK FORCE CASE - TEAM A
~~REGIONAL~~ CHIEF INSPECTOR INTEREST
(6-14-82)

RESTRICTIONS: RULE 6E MATERIAL INCLUDED

POSTAL INSPECTOR: J. A. Holland /ag

POSTAL INSPECTOR IN CHARGE: Harrisburg, PA 17105-9000

REVIEWERS' INITS											
DATE											

DISTRIBUTION			ROUTING					
INITS	DATE	AGENCY	INITS	DATE	TO	INITS	DATE	TO
		Inspection Service ONLY			Chief Inspector			
		USPS			RCI			

1. Personal attention has been given this case at Harrisburg, PA on a continuing basis since submission of the preliminary report dated May 31, 1984. Basis for the case was a report dated March 19, 1982 sent to the Postal Inspector in Charge, Philadelphia, PA, by Joseph Modla, an Examiner for the Federal Deposit Insurance Corporation, reporting an alleged check kiting scheme involving the E. F. Hutton Company, Inc. using an account at the United Penn Bank, Wilkes-Barre, PA, among others.

2. As reported in the latest preliminary report, task force efforts during the last three weeks of May were primarily directed toward completing an inventory of potential Grand Jury/Trial Exhibits, pulling documents for individual counts and completing charting tasks. Those efforts were completed during the month of June. In addition, considerable time was spent with Assistant U. S. Attorney Albert R. Murray, Jr. for the purpose of completing a draft of a proposed indictment. That task was completed on June 22, 1984.

[redacted]

[illegible]

PS Form
Mar. 1978 2029

* * * * * * *

The proposed indictment is approximately 650 pages in length and ~~was used by~~ Assistant U. S. Attorney Albert R. Murray, Jr. and U. S. Attorney David Dart Queen in their meeting with the Attorney General's staff in Washington, D.C. on June 25, 1984 (rescheduled from June 15, 1984 as indicated in the last preliminary report).

3. The appearance of Grand Jury witnesses continued at Harrisburg, PA with witnesses appearing on

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4. Through the use of the IBM Personal Computer and the Lotus Software Package, charts relating to the kiting activities of the company at banks in Wilkes-Barre, PA, Williamsport, PA and Harrisburg, PA, all in the Middle District of Pennsylvania, have been prepared. These charts show the difference between the customer money deposited into the various E. F. Hutton and Company, Inc. Branch Bank Accounts, the additional deposit of kited funds in these accounts and the daily drawdown of those accounts throughout the period of the kite. It is interesting to note that the kite was not being conducted simultaneously in each location. It is also interesting to note that the kited funds represent approximately

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8. Considerable effort was also expended by members of this task force in the preparation of computer charts and other charts for use by Assistant U. S. Attorney Albert R. Murray, Jr. and United States Attorney David Dart Queen in their meeting with the Attorney General's staff on June 25, 1984. Prior to the meeting, Assistant U. S. Attorney Murray met with Mr. Robert Ogren, Chief of the Fraud Section, Criminal Division, for four hours on June 25, 1984 to explain the investigation. At 4:00 P.M., Assistant U. S. Attorney Murray and U. S. Attorney Queen met with the rest of the staff for a scheduled one hour meeting which lasted until 6:30 P.M. As a result of the presentation, the Attorney General's staff acknowledged that they had never experienced an investigation of this magnitude and that they would not agree to any plea agreement that did not include individual defendants in addition to the corporations.

* * * * * * *

10. Assistant U. S. Attorney Murray was commended by the staff for his competence and thoroughness in handling this investigation without the assistance of other prosecutors. According to Mr. Murray, he said that he is not without assistance, he has 15 of the best investigators available assisting him, U. S. Postal Inspectors.

11. Additional reports will be submitted on a continuing basis.

J. A. Holland
Postal Inspector

Mr. **Murray**. I explained that before, that I used that document as my working document.

Mr. **Smith**. I understand.

Mr. **Murray**. For various purposes, and I threw in all the various practices.

Mr. **Smith**. You didn't feel at that time that the industry practice which you are alluding to now had been so violated as to constitute an illegal scheme in June 1984?

Mr. **Murray**. I was developing the theories to make it a legal scheme, the aggressive money management practices.

Mr. **Smith**. I am just trying to understand.

Mr. **Murray**. I am trying to make you understand. One thing I am laboring under what I can't do for you, and which I don't think has ever been done in all these hearings, I haven't been able to really explain to you what makes this scheme so unique, because I haven't been able to explain all the chains, the excessive overdrafting, the many flip-flops, the concentrations.

Mr. **Smith**. We have had a number of people do that for us.

Mr. **Murray**. I am the one that developed the scheme.

Mr. **Smith**. I understand. We have also had some of the postal people in here, and we had an official from Federal Reserve. I am not saying you couldn't do a heck of a lot to help us.

Mr. **Murray**. John Holland and myself along with Peter Clark and Mr. Ogren developed the theory. One of the problems with this case was—I would like to answer your question specifically—one of the problems with this case is that the public has a perception it is something that is done by everybody. What makes it a unique disposition is the uniqueness of the crime and the activity which we made a crime so that that is what the whole uniqueness about it is.

Mr. **Smith**. Outside industry practice.

Mr. **Murray**. What I am trying to do is like if I had it open to a jury, KISS, keep it simple stupid, however, during the course of the area in trial the very specifics would have been dissected which I haven't had an opportunity to do for you.

Therefore, when you draw conclusions like culpability, lining pockets, et cetera, that is dependent upon the practice. If I could now be specific which I haven't been able to fully explain, but specifically the corporation benefited by 90 percent. The individuals had a 10-percent profit level.

They believed, they were operating for the sake of the collective whole of the corporation, period, and that everybody within the corporation would benefit from that activity.

Mr. Bacon, Mr. Bacon did that. He made his money as well as everybody else did to benefit. To say that senior management didn't know of the practice, I have said it over and over and over again that senior management—if you want me to define lower level management, senior management, first level management, executive management knew of the practice of aggressive cash money management, endorsed the practice of creating float and going after float in this banking system, and that was a part of current industry practice.

They were operating under that assumption and actually performing the cash management practices that they did, and specifically what negates their criminal intent, one small document which you have is the First National Bank of Chicago document.

If you analyze that document, you will see each and every practice that E.F. Hutton did is outlined specifically in that document. That document was prepared by the University of Georgia, University of Indiana in connection with a research abstract, and was sent all over the country, and that is what Tom developed his theory.

I am going to tell you that other corporations in this country in the cash managers are using that as certain standards. They feel that float exists in the system, and therefore they can go after that float, even if it means creating and expanding that float. They believed they were justified in their mind in doing it, and what makes them justified is that the banks are not screaming about it, so that is what negates the criminal intent.

That is what lining their pockets is not based upon a violation of a criminal act, but based upon them thinking they are doing aggressive business tactics, and what we have said, it is no longer aggressive, people, it is now going to be criminal.

Mr. Hughes. The gentleman's time has expired.

Mr. Lungren.

Mr. Lungren. I would like to ask you the question if you can go into the uniqueness of this and I know it is going to take more than 5 minutes but my children are here and I have to go. I hope sometime I can sit down and talk with you and I hope we can get to that.

Mr. Murray. I will come back again if you want.

Mr. Lungren. Maybe we can start with those questions at the beginning.

Mr. Murray. Sure, fine.

Mr. Lungren. At this point in time, also, this is my own observation, I would understand you might think some Monday morning quarterbacking might be going on.

Mr. Murray. That is OK. Checks and balances, the whole system of Government is based upon checks and balances.

Mr. Smith. That is the whole question I want to ask you because there has been the assertion made that we ought to be concerned about your prosecution versus the Justice Department and you said absolutely that you were never compromised by the Justice Department.

Mr. Murray. No.

Mr. Lungren. I do have a question about this though. We have a proper oversight as far as Congress is concerned. It is fundamental to a proper balance between the parties, but I wonder if there are ever instances that you could conceive of where congressional oversight into a prosecution of a case could in fact render the independence of your judgment less than what you would like it.

Mr. Murray. Let me put it this way. I think that the committee's function as an oversight committee is proper. I think that it ought to occur. I think though it ought to occur properly, but not as a result of any political maneuvering between the Justice Department and this committee.

That if there are hard relationships between the two and there are ill feelings between the two, they both, both the Department of

Justice or whatever who is behind this table they ought to pull back from whatever ego or political considerations there are and think about the overall well-being of the country and to do that you have to be disinterested and you have to be an impartial party.

As far as I am concerned as a prosecutor, it causes me to hesitate, when I know that I am subject to the oversight by—I don't worry about you challenging whether I am good or bad or not. I don't care about that. I am always trying to improve myself as a prosecutor and you can always second-guess me. I have got no problem with that. I am always going to continue to be better.

I do have a problem, however, when the public may perceive that there is a judge, a jury and an executioner and that judge, jury and executioner may because of the way it looks like there is a paranoia down here—I am not from down here, I am not familiar with how things are done, but that there is suspicion between different agencies in the Government, it seems like.

I guess the same suspicion I have when I go back, the love-hate with the banks, the love-hate with politicians, so it is like when there is suspicion between the various branches of Government, what it does, it leads in my opinion to kind of a paranoia, and it kind of distorts the way people view things to the benefit of the public, because sometimes what we do is we take a very special area of expertise and put it out to the public and think they are going to understand when they are not, and I think we have a considered responsibility.

Mr. LUNGREN. I didn't want to unduly put you on the spot.

Mr. MURRAY. Well, you did.

Mr. LUNGREN. I frankly am concerned. If we are trying to make a connection between undue influence on you, and frankly, it seems to me you are the best witness as to that, and you have specifically said it is not true, you will live and die with this case, you will live and die with the disposition of the case, frankly, I get concerned when we so closely question your judgment.

Mr. MURRAY. You have got to do that.

Mr. LUNGREN. I am making an observation. That bothers me because, damn it, we can't all be prosecutors, and I think you guys have got to worry about, yes, your supervisor. I don't think you should need to have to worry about us coming back and recasting your case.

I don't know all the facts of this case. I didn't spend 2½ years doing this case, and none of us did here, and I just have some very serious concern about so closely questioning the judgment of a line prosecutor, who did a first impression case.

Frankly, I think we ought to have a congressional hearing to give you some sort of award.

Mr. MURRAY. Give it to the postal inspector.

Mr. HUGHES. I will say to my colleague from California I can't let that go by, that I perceive our role apparently a little differently than my colleague. This committee, the House Judiciary Committee, has oversight responsibility, and nobody has questioned Mr. Murray's integrity. We are looking at a myriad of aspects of the case, trying to understand it. We have been now 6 months trying to just get talking to understand the case a little better, and I don't think Mr. Murray is easily intimidated by anybody, from what he tells me.

Mr. MURRAY. I am not.

Mr. HUGHES. And that is the way it should be. We don't think anybody that has done an adequate job has anything to fear.

Mr. Mazzoli.

Mr. MAZZOLI. Thank you, Mr. Chairman.

Let me just say early on my friend from Florida asked the question of you, Mr. Murray, my friend from Florida asked a question a moment ago which you answered honestly and which I really salute you for, in which he said something to the general effect, would you have done something differently, what would you have done differently.

You said nothing, and let me just say that if I were in your spot, I would have said with respect to Mr. McCollum, I would have done maybe nothing with respect to this case, because if I knew I had to be called in here and had to explain all these details, minutia, I might say the hell with it and just not prosecute a landmark case, and I think the country would have been a lot worse for it, so let me just say from my standpoint that if you had answered the question that way, I would have said that is an honest answer.

You answered it even more honestly by saying "I would have taken this kind of kicking around, this kind of oversight, knitpicking willingly, because I did a good service for the country."

Let me just say also my friend from Florida, Mr. McCollum in his opening remarks on this last round said something which I think is very appropriate. He said all of the detailed information which you gave to the questions of our chairman and others, and it was very detailed, signifies more than anything else your knowledge of the case, the background, the study.

This was no casual case. This wasn't some incidental little thing. This was a commitment on your part in which you delved into it with the greatest detail that perhaps any assistant prosecutor has in your area of the country.

And I would say to go back to your reference to Mr. Bill Safire of the New York Times—in this sense. Safire is a wordsmith. You know his Sunday New York Times piece on words which I read all the time, and he coined the phrase, mego, my eyes glaze over with respect to when you went into your detailed explanation about this thing I looked around the room and most of us had our eyes glazed over because only a very few people in this country can follow the intricate scheme of threads which you have laid out and let them bind together at some point called prosecution, and you have been able to do it and I salute you for it.

Very few others could do it, and so accordingly that long detailed exposition more than ever bolsters my argument that the only question this committee should really ask of you is did Trott lean on you? Did Smith lean on Trott who then leaned on you. If we can't get any affirmative response to that question, and you have said many times that is not the case, then all we are doing is in fact Monday morning quarterbacking your decision and I don't think it is fair.

The chairman well knows that I had very strong reservations about this hearing, about the method that was to be carried out.

The committee made its judgment and that is fine, but I do worry about what happens to prosecutors down the line carrying out a case if they may have to come in here to this kind of a setting, and make all the detailed explanations.

This is an exceptional case. I am sure our chairman will keep this whole thing in bounds, but it does indeed worry me that we may have set a precedent here, which could very well cause other prosecutors to shy away from the big case, which goes into Wall Street instead of Main Street, because they could hurt you. They can come back to haunt you. The Main Street case done. Who gives a damn about Main Street? They do give a damn about Wall Street, so this might actually cause prosecutors to lay off the important case and devote their scant scarce resources to the easy case which doesn't however, make landmark decision.

So I just want to sum up and shut up here, which I should have done probably before I started, by saying that I think the committee has an oversight responsibility they must carry out, but it should carry out with Mr. Trott, with Mr. William French Smith, with the people in the Justice Department who it is alleged may have had some role to play in deciding on a slap on the wrist instead of a kick in the pants, and that is all.

Mr. SMITH. Would the gentleman yield?

Mr. MAZZOLI. Yes.

Mr. SMITH. Thank you.

While I agree with much of what my colleague has said, from your point of view I can understand the feeling that you would have about what he said and the veracity of what he said, I take a slightly different view, and I want to use what you started out early on saying. You apparently have a great devotion not only to the law but to the system of justice in this country.

Under the Constitution we have a role, the administration has a role, and under that you have a role.

Mr. MURRAY. Right.

Mr. SMITH. I would hope that you would want that always to be the case.

Mr. MURRAY. Yes.

Mr. SMITH. And that if by coming in here in some other case we would have found that there was undue influence on a prosecutor whose independence was then removed from him, meaning that justice did not get served in a particular case——

Mr. MURRAY. Right.

Mr. SMITH [continuing]. That we would have done the right thing.

Mr. MURRAY. Yes.

Mr. SMITH. The fact that you have said affirmatively to our question there was no influence, I don't think means that this hearing was invalid. I think it reaffirms the process.

Mr. MURRAY. Both sound good, both of those.

Mr. MAZZOLI. I am glad to hear that.

Mr. SMITH. That is the way I would tend to view it, and as long as we are doing it in the same spirit in which you approached this case, we are both doing our jobs, Mr. Murray.

Mr. MURRAY. You know what, I would come back here 100 times and explain to you what I did with my job. I just hope that you all, I hope, will have the guts and the determination to eventually see that what we did was the right thing.

Mr. Smith. Right.

Mr. Murray. And not to—I would have done anything to——

Mr. Mazzoli. Let me say this because I want to reclaim my time. The chairman wants us out of here and I am sure your daddy has other business.

Mr. Murray [continuing]. Don't worry about him.

Mr. Mazzoli. He is an eminent judge.

Let me just say this: I think that if our country has in its service assistant U.S. attorneys, and I say this in all candor, of the quality, the integrity, the intelligence and professionalism that you have displayed, Mr. Murray, then I say Democrat, Republican, Independent, or whatever, we are as a nation being well served. I salute you on a tough day. You handled it very well.

Mr. Murray. Thank you, sir.

Mr. Mazzoli. Mr. Holland, I think you have done an excellent job as a team and individually and I want to thank you, and as I say, I might have gone to Fomon, I might have put him in the gun sights, because I just might have.

Mr. Murray. Right.

Mr. Mazzoli. But the fact of the matter is what you did, you did in good faith. What you did was having examined a mountain of information, and I think your judgment ought not to be second-guessed.

Mr. Hughes. I think that my colleagues have already indicated some of my own feelings. I differ with some of my colleagues insofar as the role of this committee. I think the check and balance is extremely important. I think my colleague from Florida, Mr. Smith, probably summed it up better than I could; that it is far better that we have a check and balance to insure that there is not that type of intimidation, so that the decisionmaking process is in the public interest. This is a most unusual case.

Mr. Murray. Yes.

Mr. Hughes. We don't have all the evidence we want now. It has taken us 6 months to get here, but you took 2 years, I understand, and I don't pretend that we understand what you understand about the case, but I understand a lot more than I ever wanted to about this particular case.

Mr. Murray. I am sure.

Mr. Hughes. And I also know that there are a lot of circumstances that gave people a reason to wonder; the timing, the timing of the luncheon, the timing of the extension of the grand jury, the fact that the case was pulled for supervision to the Justice Department in Washington all raise a number of issues. The fact that we have a scheme that could range anywhere from $15 to $250 million, that you have people like Bacon making $120,000 in a month from his interest drawdown, from his activity. The fact that you have corporate executives that do benefit, corporate executives that benefit because in fact their bonuses and their salary reflects what the company is making in a given year; the fact that people of this country were bilked out of millions of dollars because of the provisional credit that is granted by Federal Reserve to banks; the fact that we did have a lot of banks that will probably never receive restitution in this case; the fact that this corporation made so much money and ended up paying a $2 million fine.

You have explained the other side of the coin, the fact it was complicated, that there was some risk involved in pursuing a prosecution. The fact that it was novel.

They are all mitigating circumstances, but I will fight for the right of this committee and other committees to make sure of the fact that we do our job like you do your job and I would hope you would view it in the same way.

Mr. Murray. Yes, I do. I will come back as many times as you want me to to explain the intricacies of the scheme and whatever you want me to do to make sure that the American public understands what we did was right.

Mr. Hughes. You and I, I think, understand the system just like I think my colleagues do extremely well. I might have come down a little differently on this prosecution than you have, but I said at the outset and I said during this hearing that I am not going to Monday-morning-quarterback you because I had to make a lot of decisions like that many years ago, and it is easy to call the shots after the fact. As I told you before, I obviously had a little more confidence in the case than you had, but again that is a judgment call now.

I have no further questions to ask. We thank you for your testimony. It has been a lengthy one. I have missed two flights. My colleague here is getting nervous because he has a train to catch. The hearing is going to stand adjourned at this point.

Thank you very much for your testimony.

[Whereupon, at 2:40 p.m., the subcommittee was adjourned subject to the call of the Chair.]

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E.F. HUTTON MAIL AND WIRE FRAUD CASE

WEDNESDAY, DECEMBER 11, 1985

House of Representatives,
Subcommittee on Crime,
Committee on the Judiciary,
Washington, DC.

The subcommittee met, pursuant to call, at 10:30 a.m., in room 2237, Rayburn House Office Building, Hon. William J. Hughes (chairman of the subcommittee) presiding.

Present: Representatives Hughes, Mazzoli, Morrison, Smith, Lungren, and Gekas.

Staff present: Hayden W. Gregory, counsel; Eric Sterling, and Virginia Sloan, assistant counsel; Fred Stuckwisch, GAO consultant; Theresa Bourgeois, staff assistant; Charlene Vanlier Heydinger, associate counsel; Brenda Lang, staff aide; Joanne Royce, staff aide; and Phyllis Henderson, clerk.

Mr. Hughes. The Subcommittee on Crime will come to order.

The chair has received a request to cover this hearing, in whole or in part, by television broadcast, radio broadcast, still photography, or by other similar methods. In accordance with committee rule 5(a), permission will be granted unless there is objection. Is there objection?

Hearing none, such permission is granted.

Today, the subcommittee is holding the last of its hearings with the Department of Justice witnesses, we hope, on the Department's handling of the E.F. Hutton case. Last Friday we heard testimony from Assistant U.S. Attorney Al Murray and the U.S. Postal Inspector John Holland about their role in the case.

Today, we will hear from Stephen Trott, Assistant Attorney General in charge of the Criminal Division for the Department of Justice; Robert Ogren, Chief of the Department's Fraud Section; and Peter Clark, attorney with the Fraud Section. These witnesses will, we expect, shed further light on the progress of the case once the Department became involved in 1984. We also want to question these witnesses about the policies of the Department of Justice for prosecuting white-collar crime cases.

As I have noted on many occasions, the Department has entered into plea bargains in a number of recent cases where corporations have been allowed to plead guilty to lesser charges where insignificant penalties have been imposed in the judgment of many people, and where no individuals have been charged. We of course have yet to determine whether the Hutton case falls within this category.

After we conclude this part of the hearing, we must deal with another issue, the Department's response to this subcommittee's subpoena for documents. Mr. Trott was the individual subpoenaed to provide these documents, and we will receive his testimony on this issue after we discuss the substantive aspects of the case.

Finally, we will also hear testimony today from Hutton chairman of the board Robert Fomon, and his executive assistant, Jay Moorhead. Their testimony will focus on one issue, the luncheon they had in November 1984 with then Attorney General William French Smith, where Mr. Fomon asked Mr. Smith to look into certain aspects of the case. We are, of course, concerned about whether this meeting had any effect on the way the case was disposed of, and in particular whether the extension of the grand jury in November 1984 was in any way connected with that luncheon.

Our first panel of witnesses this morning consists of Stephen S. Trott, the Assistant Attorney General for the Criminal Division, U.S. Department of Justice; Robert W. Ogren, Chief of the Fraud Section of the Criminal Division; and Peter B. Clark, a trial attorney in the Fraud Section of the Criminal Division. Mr. Trott, Mr. Ogren, and Mr. Clark, on behalf of the Subcommittee on Crime, we welcome you here this morning.

Pursuant to clause 1 of rule 11, and clause 1 of rule 10 of the Rules of the House of Representatives, this hearing of the Subcommittee on Crime of the Committee on the Judiciary is an oversight investigation of the E.F. Hutton mail and wire fraud case.

Let the record indicate that pursuant to clause 2 of rule 11 of the Rules of the House of Representatives, copies of the Rules of the Committee on the Judiciary, and of clause 2 of rule 11 of the Rules of the House of Representatives in particular, have been made available to the witnesses and are now available at the witness table.

Mr. Trott, Mr. Ogren, and Mr. Clark, you have a right to counsel to assist you in the course of this morning's proceedings. Are you accompanied by counsel?

Mr. TROTT. No.

Mr. CLARK. No.

Mr. OGREN. No.

Mr. HUGHES. Do you desire counsel?

Mr. OGREN. No.

Mr. TROTT. No.

Mr. CLARK. No.

Mr. HUGHES. Gentlemen, will you rise at this point. I am going to place you under oath. Raise your right hand. Mr. Trott, Mr. Ogren, Mr. Clark, do you solemnly swear or affirm that the testimony you are about to give to this committee is the truth, the whole truth and nothing but the truth, so help you God?

Mr. TROTT. I do.

Mr. OGREN. I do.

Mr. CLARK. I do.

Mr. HUGHES. Please be seated.

Mr. Trott, we have received your prepared statement. In fact, the statement was prepared I believe back in June originally, June 5, and that will be made a part of the record in full, and you may proceed as you see fit.

I just might note that it is the chair's intent to break, if we don't have votes—and we just may not have votes—in about an hour and a half. I know that you have a bad back, and so we are going to try to make sure that you don't have to sit for a long period of time. You may proceed.

TESTIMONY OF STEPHEN S. TROTT, ASSISTANT ATTORNEY GENERAL, U.S. DEPARTMENT OF JUSTICE; ROBERT W. OGREN, CHIEF, FRAUD SECTION, CRIMINAL DIVISION, U.S. DEPARTMENT OF JUSTICE; AND PETER B. CLARK, TRIAL ATTORNEY, FRAUD SECTION, CRIMINAL DIVISION, U.S. DEPARTMENT OF JUSTICE

Mr. Trott. Thank you, Mr. Chairman. We certainly appreciate the opportunity to appear before this committee today to talk about not only the Hutton case but our general policies with regard to white-collar crime. It is our view that our Nation does face a white-collar crime program that affects all aspects of our economy and lives. Viewed in terms of dollar impact, the losses caused by white-collar offenses are staggering.

In our view, white-collar crimes cost Americans hundreds of billions of dollars every year, dollars that they can ill afford to lose. Over $100 million is lost annually through high-pressure boiler-room operations fraudulently selling commodities such as precious metals by telephone.

Over one-half billion dollars were lost in the past 5 years in real estate investment schemes in California alone. Hundreds of millions of dollars have been lost by tens of thousands of investors who have been victimized by fraudulent financial service brokers operating in Florida, California, Utah, Ohio, and New Hampshire.

Approximately $80 million was lost in the J. David investment fraud scheme on the west coast—a scheme that culminated a number of months ago in a financier's entry of a plea of guilty. Almost $700 million in losses resulted from a Tennessee bank fraud scheme that concluded this year with Jake Butcher's plea of guilty several weeks ago. Just this week Butcher received a sentence of 20 years in prison.

White-collar crime seriously harms the well-being of our Nation. It siphons billions of dollars a year from our economy. It steals the life savings of investors. It adds to the costs of goods and services, and diminishes the revenues otherwise available to the Federal and State treasuries. It aggravates the financial burdens of all Americans, who are the indirect victims of fraudulent offenses as well as the direct ones.

Mr. Chairman, you asked briefly about our policies with respect to white-collar crime. I make this opening statement simply to indicate to you that we regard this as one of our highest priorities in the Department of Justice. In the last 5 years we have increased the percentage of cases in our inventory of white-collar crimes, and we are pursuing these with a programmatic intensity that in my view, having been a prosecutor for 20 years, is very well deserved.

As far as the kinds of cases we are bringing, they are priority impact cases that affect areas that we think relate to the financial underpinnings of the country. The Economic Crime Council, which was started by William French Smith, was designed to make sure that we are using our resources effectively, and working in areas that will have the greatest impact on behalf of the taxpayer and the American citizen, to address this rather large problem.

This year alone, if you look at the overall kinds of cases that we have brought, and the level at which we are operating, I think you will be impressed at the breadth and scope and focus of this program. General Electric, for example, was indicted and convicted in Philadelphia of charges of defrauding the Defense Department, and was simultaneously suspended for a short period of time from doing business with the U.S. Government.

A number of individuals, employees of General Electric, were also indicted and convicted in that case. As I mentioned before, Mr. Jake Butcher entered pleas of guilty to several indictments and has been sentenced to 20 years in prison for looting a series of banks in Tennessee and Kentucky. Two of his accomplices have also been convicted in that case. Paul Thayer, Deputy Secretary of Defense, and Dallas stockbroker Billy Bob Harris were sentenced in Washington, DC, to 4 years in prison for obstruction of justice in connection with their roles in a million dollar insider stock trading scheme.

A 35-year prison term was imposed on Fred Soudan in Houston, TX, for his role in masterminding the largest maritime fraud in history—the infamous sinking of the supertanker *Salem* off the west coast of Africa.

The Attorney General announced a comprehensive overhaul of and improvements in the mechanism for referring bank fraud cases for criminal prosecution.

A number of defendants were convicted in Texas of Foreign Corrupt Practices Act violations.

J. David Dominelli, convicted and sentenced in a scheme affecting 1,500 people.

Conviction in Detroit of the LeBlanc brothers for an investment scheme in which 800 investors lost $10.5 million.

Indictment in Florida of convicted conman and boiler room operator Jack Rose in a scheme that bilked 1,200 investors out of $12 million in a precious metals scam.

Conviction of GTE and the indictment of a number of individuals for fraud against the government.

The conviction just yesterday by a plea of guilty by Ivanhoe Donaldson for looting the city of the District of Columbia.

Conviction of Rockwell International for mischarging; indictment of General Dynamics in the *Divad* case for mischarging; indictment of George Sawyer in connection with his leaving the Government and going to work for General Dynamics; and hundreds of other cases. These cases represent the view of the Economic Crime Council that there are certain areas that are very important to the financial soundness of the United States.

The Economic Crime Council, as I said, came together and found six principal priority areas that we focus on, not to say that we don't look at other cases, but these are our focus.

They involve defense procurement fraud, because that is an area in which enormous quantities of taxpayer dollars are spent to keep this Nation strong, fraud against banks, because that is a very important underpinning of the financial strength of America, and savings and loan institutions, investment boiler room frauds, because of the scope of those operations and the amount of money they rake out of the economy, money laundering, various types of security frauds, health-care frauds. We must strike decisively and effectively against such economic crimes, because they corrupt the economic integrity of our society and its institutions.

The *E.F. Hutton* case, as you were told last time by Al Murray, the lead lawyer on the case, is a case of first impression. Speaking as the Assistant Attorney General of the Criminal Division, I can tell you it is one of the most complex cases that I have ever been associated with, and I personally, and the Department, are extremely proud of the efforts set forth by Al Murray, by John Holland and the team of postal inspectors, by Bob Ogren, the chief of my fraud section, and by Peter Clark, the trial lawyer that we added to that complement.

I am delighted to be here today to be able to answer your questions about the handling of this case, or the policies, practices and procedures of the Justice Department.

[The statement of Mr. Trott follows:]

Department of Justice

STATEMENT

OF

STEPHEN S. TROTT
ASSISTANT ATTORNEY GENERAL
CRIMINAL DIVISION

BEFORE

THE

SUBCOMMITTEE ON CRIME
COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

CONCERNING

E.F. HUTTON CASE

ON

DECEMBER 6 AND 11, 1985

**THIS STATEMENT WAS ORIGINALLY PREPARED
FOR DELIVERY ON JUNE 5, 1985

I appreciate this opportunity to discuss with you the subject of economic crime enforcement and to give you our perspective on the E.F. Hutton prosecution.

A month ago, in a major speech in Boston, the Attorney General reaffirmed the commitment of the Department of Justice to a vigorous federal white collar crime enforcement program. The Attorney General's statement could not have been more timely. It occurred in the midst of series of landmark events in white collar crime enforcement and at a time when the importance of effective federal white collar crime enforcement is more critical than ever.

I am particularly pleased to have the opportunity to restate for this Subcommittee our commitment to a strong white collar crime enforcement effort.

Our nation faces a white collar crime problem that infects all aspects of our economy and lives. Viewed in terms of dollar impact, the losses caused by white collar offenses are staggering. White collar crimes cost Americans hundreds of billions of dollars every year.

Over $100 million is lost annually through high pressure "boiler room" operations fraudulently selling commodities such as precious metals by telephone. Over one-half billion dollars were lost in the past five years in real estate investment schemes in California alone. Hundreds of millions of dollars have been lost by tens of thousands of investors who have been victimized by fraudulent financial service brokers operating in Florida, California, Utah, Ohio, and New Hampshire. Approximately $80 million was lost in the J. David investment fraud scheme on the West Coast -- a scheme that culminated two months ago in a financier's entry of a plea of guilty. Almost $700 million in losses resulted from a Tennessee bank fraud scheme that concluded with Jake Butcher's plea of guilty several weeks ago. Just this week Butcher received a sentence of 20 years in prison.

White collar crime seriously harms the well-being of our nation. It siphons billions of dollars a year from our economy. It steals the life savings of investors. It adds to the costs of goods and services, and diminishes the revenues otherwise available to the federal and state treasuries. It aggravates the financial burdens of all Americans, who are the indirect victims of fraudulent offenses as well as the direct ones.

The consequences of white collar crime are, however direct and visible. It causes banks to fail. In fact, fraud is a factor in over half of the bank failures in the past five years. White collar crime adds hundreds of millions, if not billions, to the cost of military purchases. It creates defective weapons and military supplies that undermine our ability to defend our nation. It destroys the public's faith in our federal programs such as Medicare and Food Stamps.

Because the economic crime problem is so widespread and the cases themselves so complex and resource intensive, it is vitally important that the federal enforcement effort not be encumbered by antiquated laws, limited techniques, or wasted efforts. The white collar crime provisions of the Comprehensive Crime Control Act enacted by Congress in 1984 were particularly welcomed. That Act toughened the penalties for Title 31 currency act violations. It enacted a broad bank fraud statute. It created an injunctive remedy to respond to the problem of ongoing criminal conduct. The fine provisions of the Fine Enforcement Act of 1984 will substantially increase the cost of committing crime for the white collar criminal. Maximum fines per violation are now $250,000 for individuals and $500,000 for corporations. Using these weapons we can seek to strip the white collar criminals -- both individuals and corporations -- of every last penny of their ill-gotten gains. Considerable progress has been made. But further progress is needed. In the near future we will submit to the Congress a comprehensive legislative package that will improve our ability to respond to defense procurement frauds. In addition, we will propose legislation that will enhance our ability to prosecute professional money launderers and will further enhance our ability to handle bank fraud prosecutions. We hope you will join us and vigorously support these legislative initiatives.

The key to any federal white collar crime enforcement effort is to use our resources as efficiently and effectively as possible. That requires selecting our priorities with care, developing close cooperation among all elements of law enforcement, crafting creative strategies and carefully utilizing our resources in the most effective manner.

In 1983, Attorney General Smith created the Economic Crime Council to serve as an advisory body on white collar crime enforcement policy within the Department of Justice. The Council is chaired by the Deputy Attorney General. Its membership includes 21 United States Attorneys and officials of the Criminal Division and the FBI, and, beginning this year, the Antitrust, Civil and Tax divisions of Department of Justice. One of the Council's principal roles has been to aid in developing white collar crime priorities. The Council, working in conjunction with the Criminal Division, has defined our law enforcement priorities sharply and clearly. We are concerned about areas that affect our national defense, our banking system, the taxpayer and the investment public. The six principal priority areas are defense procurement frauds, frauds against banks and savings and loans, investment "boiler room" frauds, money laundering, various types of securities frauds, and health care frauds. We must strike decisively and effectively against such economic crimes because they corrupt the economic integrity of our society and its institutions.

One priority area of prosecution -- bank fraud -- is of particular relevance to today's hearings. Fraud against banks is a major concern of the Department of Justice for one simple reason. Over one half of the bank failures in the United States in the last five years were either caused by or related to criminal conduct. That fact is deeply disturbing. The nation's economic health turns on stability in its banking institutions. With this objective in mind, former Attorney General Smith and the heads of the bank regulatory agencies created a task force last December to revise the referral mechanism that brings bank fraud cases into the criminal justice system and to develop improved methods for handling major bank fraud cases. The result of that effort, announced by Attorney General Meese two months ago, is an interagency agreement which has already improved our handling of significant bank fraud cases. One specific objective of the task force -- and one relevant to these hearings -- was to improve the enforcement mechanism so that action could be taken to prevent banks from failing.

Before turning to the specific facts of the Hutton case, I want to address briefly two other points.

We believe there are a number of ingredients to a successful criminal enforcement effort. Certainly the dominant one is the prosecution, conviction and imprisonment of all individuals who perpetrate crime. But that traditional solution, in many instances, does not go far enough. It does not take into account the need to prevent crimes before they occur, or to bring cases which by their scope, and the swiftness by which they become final, provide clear, dramatic warning that specific conduct will be prosecuted. It also ignores the need, in the very special setting of offenses committed to benefit corporations, to impose direct and substantial sanctions upon the corporation, in addition to those imposed on the individuals, and to force the corporation to adopt internal control mechanisms that will prevent future criminal conduct and substantially alter the ways in which the corporation conducts its affairs.

Our white collar crime enforcement program is a varied and successful one. Statistics tell us we are prosecuting more economic crime now than ever. White collar crime prosecutions have risen as a percentage of total federal prosecutions from 8% to 1970, to 20% in 1980 and to 24% in 1983 and 1984. Numbers, however, do not begin to tell the full story. Certainly the cases are more significant than ever. Within just the last 70 days our national effort includes these remarkable events:

- General Electric Company was indicted and convicted in Philadelphia charges of defrauding the Defense Department and was simultaneously suspended from doing business with the United States Government. Two individual employees of General Electric were also indicted for perjury and obstruction of justice with respect to the grand jury investigation in the case.
- Jake Butcher entered guilty pleas to several indictments and has been sentenced to 20 years in prison for looting a series of banks in Tennessee and Kentucky. Two of his accomplices have also been convicted and await sentencing.
- Paul Thayer, former Deputy Secretary of Defense, and Dallas stockbroker Billy Bob Harris were sentenced in Washington, D.C. to four years in prison for obstruction of justice in connection with their roles in a million dollar insider stock trading scheme.

- a 35-year prison term was imposed on Fred Soudan in Houston, Texas, for his role in master minding the largest maritime fraud in history -- the infamous sinking of the super tanker "Salem" off the west coast of Africa.
- the Attorney General announced a comprehensive overhaul of and improvements in the mechanism for referring bank fraud cases for criminal prosecution.
- six defendants were convicted in Texas of Foreign Corrupt Practices Act violations in the $10 million Pemex/Crawford foreign bribery scheme and are awaiting sentencing.
- the conviction of J. David Dominelli in San Diego on mail fraud charges in connection with the J. David Company an investment scheme that defrauded 1,500 people out of $200 million.
- conviction of the LeBlanc brothers in Detroit for an investment scheme in which 800 investors lost $10.5 million.
- Indictment in Florida of convicted con-man and boiler-room operator Jack Rose in a scheme that bilked 1,200 investors out of $12 million in a precious metals scam.

- o Conviction of E.F. Hutton and Company, Inc. of 2,000 counts of mail and wire fraud in a nationwide check-kiting scheme and unprecedented civil injunctive relief.

I seriously doubt whether there was ever a collection of more significant white collar crime cases resolved in such a short period of time. And I can promise you more are to come in the months ahead, most in our national priority areas.

We are proud of this record and, with respect to the subject matter of today's hearing, we are proud of the results achieved in E.F. Hutton prosecution. By any standard, the Hutton case is a landmark and its law enforcement accomplishments are noteworthy.

The facts of the Hutton case are enormously complex as you will learn in our detailed briefing. Most public comment on the results in the case has been based both on a serious misunderstanding of the unusual factual and legal setting of the case and a failure to appreciate the litigation risks faced in the prosecution. We have heard no criticism from regulators, bankers, lawyers and responsible corporate managers who have taken the time to study what was done in the Hutton case. The message of the Hutton case has been read loud and clear by those immediately affected by it. To aid your understanding, I am appending to this statement a summary of the Hutton case, which includes a description of its legal setting, the litigation risks we confronted and the relief we obtained.

The Hutton prosecution is without precedent in the federal system. Some of the practices embraced by our enforcement action were probably legal until enactment of the bank fraud statute last October. Nevertheless, they constituted serious abuses that threatened to inflict significant losses on banks. The perpetrators did not believe they were committing a crime, although in fact their acts now are clearly illegal and many of them were at the time. The investigation covered 3 years and ultimately involved the analysis of 7,000,000 million documents. On top of these difficulties, we recognized that many of Hutton's most serious cash management abuses could not be. reached by a conventional criminal prosecution.

Our prosecutors had to choose. The first option: a conventional prosecution of Hutton and two mid level individuals, would have been costly, inefficient, had a questionable prospect of success and could not reach the most widespread abuses of Hutton and the rest of the money management community. The second option: a comprehensive settlement that we judged would address most directly the serious problem of widespread money management abuses.

For what amounted to deceiving banks into giving it interest-free unsecured short-term loans, Hutton was required to plead guilty -- not nolo contendre but guilty -- to an unprecedented 2,000 felony counts of intentional mail and wire fraud. It was fined $2,000,000, the maximum the law allows for this unparalleled number of counts, and a sum which makes it the steepest fine in the history of our white collar enforcement effort. Hutton was also required to pay the Government $750,000 to cover the costs of the investigation. Those costs are ordinarily not recoverable, even with a jury verdict of guilty. Additionally, the new injunctive provision of 18 U.S.C. §1345 was used for the first time since its enactment by Congress in October 1984 to enjoin all of Hutton's cash management abuses, not just those precisely identified in the criminal information, many of which were not criminal prior to enactment of the Comprehensive Crime Contract Act.

The Department of Justice also required that Hutton immediately make full and complete restitution, with interest, to each and every one of the bank victims without regard to the federal district in which they reside. Rarely is there a criminal fraud case where this much immediate benefit flows to victims. Usually victims interests are handled as an afterthought. It is incorrect to assume or infer that restitution is limited to the $8,000,000 Hutton has reserved for this purpose. Hutton is obligated to pay back the total amount obtained fraudulently, plus interest, whatever that may be. In sum, this is the most comprehensive program of restitution ever developed in a federal criminal case.

As I noted before, one of the important priorities of the Department of Justice is the protection of the banking industry itself from fraudulent schemes. Predatory money-management practices and cash concentration systems have become, in the hands of a few, a science that can threaten our banking institutions. Professionals working in that specialty have associations which sponsor conferences, exchange information, and publish articles. Their sophisticated activities and techniques have a definite impact on our nation's banks and financial institutions of which few people are aware. The Federal Reserve has been highly critical of "float creating" and "float-playing games," of which Hutton's was an extreme example, and we are in agreement with that concern. Hutton's practices had tremendous potential for harming banks, particularly the smaller, more vulnerable ones. The injunction covers conduct that we were unable to include in our criminal charging document and thus we achieved important multiple objectives in a single decisive stroke. This conviction and injunction sent a clear message to professional money managers around the country. There should be no doubt that these kinds of abuses are criminal and will be prosecuted.

The public must have faith in the stability of our financial institutions, and they must have it today, not tomorrow. Naming numerous small banks victimized by Hutton in an unresolved indictment and alleging widespread fraud and losses had the capacity to undercut public confidence in those banks. If that route had been chosen and runs on deposits had developed, the situation would have been highly undesirable. One only has to look to the recent problems in Ohio and Maryland to see how fragile public confidence can be when it appears to depositors that the financial institution to whom their money has been entrusted is on shaky ground. The plea of guilty, the injunction plus complete restitution without a risky, costly, and lengthy trial achieved our objectives, now, not two or three years from now. The word is out. The cloud is gone. The matter has been favorably resolved without the uncertainties and vagaries of the protracted trial we estimate would have involved some 300 witnesses and several hundred thousand documents.

Several aspects of the case deserve mention. As we have described more fully in the case summary submitted with this testimony, check kiting became difficult to prosecute as a result of the Supreme Court's decision in United States v. Williams, 458 U.S. 279 (1982). The theory prosecutors traditionally employed was that an overdraft check constituted an "overvalued security" or a "false statement" to the bank which honored it. The Supreme Court rejecting that theory held that a check made no representation as to the state of the bank account on which it was drawn, and, moreover, was not an overvalued security.

As you know, we recommended remedial legislation to the Congress to cure this problem and that provision, 18 U.S.C. §1344, was adopted as part of the Comprehensive Crime Control Act of 1984.

Before passage of §1344, the principal alternative to §1814 as a check kite prosecutive vehicle was mail or wire fraud in the limited cases where those statutes applied. In the Third Circuit, however, Williams took its toll on the "mail fraud/wire fraud" approach to prosecuting check kites. In United States v. Frankel, 721 F.2d 917 (3rd Cir. 1983), the Court relied on Williams to conclude that a check kite could not be charged under the "false pretenses, representations and promises" clause of 18 U.S.C. §1341 because a check was not a representation. Frankel left open the possibility of a prosecution under the "scheme to defraud" clause, but failed to explain how that could be done.

The net effect of the Williams and Frankel decisions was to circumscribe our ability to prosecute check kites. Finding a theory that would not lead to a dismissal under either Williams or Frankel was not simple. The theory we adopted, and which is reflected in the Hutton criminal charges, focused on a misrepresentation of Hutton's relationship with its banks: Hutton held itself out as creating depository accounts to handle only customer money where in fact the accounts were used to process huge overdraft checks. This is a rather unconventional and untested prosecutive approach to check kiting and turned completely on our ability to establish persuasively that the depository accounts were intended for a highly specific limited use. Obviously, this creative circumvention of Williams and Frankel would have been tested vigorously pre-trial and post-conviction.

The second legal defense we expected was a claim of good faith. Hutton alleged it was guilty merely of aggressive money management. In fact, Hutton insisted that they had done nothing wrong and had only attempted to "recapture float" that did not belong to the banks. Hutton insisted that its practices were no different than those of other companies.

The third possible legal attack on our case, available to the individuals who might have been charged, was the simple claim that each was acting pursuant to corporate policy and, because Hutton had the means to pay the banks, the requisite mens rea or intent to defraud was absent.

As to the individuals primarily responsible in a criminal sense for this activity, there were essentially two key people. Beyond that they cannot be identified -- nor can the evidence against them be detailed or characterized -- because of Rule 6(e) of the Federal Rules of Criminal Procedure that requires continuing secrecy with respect to matters occurring before a grand jury. However, neither individual was a high-level executive of the company.

In assessing the manner in which this case ought to be handled, our prosecutors started from the proposition that individuals ought to be held personally responsible for their criminal misconduct. This is our normal policy from which we deviate only when faced with a compelling reason to make an exception. Pursuing at trial the known individual authors of these abuses would have had some merit, but not at the expense of foregoing the opportunity to dictate the key terms of, and seize without delay, this extraordinary settlement. To prosecute the individuals would have required us to drop the settlement in favor of a protracted court fight that would have taken years to complete. That was the choice. Our career prosecutors opted for the numerous overwhelming benefits of the immediate solution, and we find their judgment to be absolutely sound and above approach. The benefits derived from the Hutton plea were so substantial that they clearly warranted an exception to our policy of affixing personal responsibility for wrongdoing.

Summary of the E.F. Hutton & Company Inc. Investigation and Prosecution

In December 1981, a check kite being operated by a number of E.F. Hutton & Company Inc. ("Hutton") branches collapsed when an $8,100,000 check was bounced by the Genessee Country Bank of Batavia, New York. This event triggered a joint inquiry by the New York State Banking Commission and the Federal Reserve Bank of New York. Ultimately an FDIC examiner learned of the incident and, because the kite involved checks drawn on the United Penn Bank in Wilkes-Barre, Pennsylvania, the examiner referred the matter in March 1982 to the United States Postal Inspection Service in Scranton, Pennsylvania, and to the United States Attorney in Scranton. Assistant United States Attorney Albert R. Murray, Jr. of the Middle District of Pennsylvania was assigned to the case.

After reviewing the allegations and events surrounding the Genessee/United Penn kite, Assistant United States Attorney Murray opened a grand jury investigation. [1/]

Staffing and Scope of the Investigation

The investigation commenced in April 1982 and continued until May 1985. Assistant United States Attorney Murray believed it possible that the Genessee kite was evidence of more wide spread abuses by Hutton. The investigation was structured to

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[1/] During the grand jury investigation the Supreme Court decided *United States* v. *Williams*, 458 U.S. 279 (1982) which drastically curtailed federal prosecutions of check kiting. See discussion *infra* under "Legal Theory and Problems."

test that theory. The investigation was staffed by Assistant United States Attorney Murray and a Postal Inspection team headed by Postal Inspector John Holland of the Harrisburg office. Assistant United States Murray, who had previously been in private practice, became an Assistant United States Attorney in January 1980. Mr. Holland has been a postal inspector for 14 years. Peter B. Clark, an experienced Criminal Division Fraud Section attorney, previously in private practice and a Special Counsel in the Enforcement Division of the Securities and Exchange Commission, joined the prosecutive team in August 1984.

The site of the investigation, for logistical and tactical reasons, was Harrisburg, Pennsylvania. One key reason was to limit the possibility of publicity. The grand juries that investigated the Hutton matter were located in Harrisburg.

During the investigation numerous witnesses testified before the grand jury, many on more than one occasion. Many witnesses insisted upon use immunity protection, which was supplied in the form of a letter in lieu of statutory §6001 immunity. In each instance, proffers were received in advance of the immunity grant. No immunized witness was a target of the grand jury investigation.

Except for those who invoked the Fifth Amendment and refused to testify, all relevant Hutton headquarters personnel were interviewed.

John S.R. Shad, Securities and Exchange Commission Chairman, was, until 1980, vice-chairman of the board of Hutton. There was no evidence nor any allegation that Mr. Shad had participated in the check scheme or indeed knew about it. Mr. Shad was interviewed and we concluded that he had no connection with the scheme.

Over 300 subpoenas were issued during the investigation. The number of documents obtained by subpoena was approximately 7,000,000. One of the principal initial tasks was to organize the subpoenaed documents pursuant to a system that permitted orderly retrieval. The documents were physically maintained at the main postal facility in Harrisburg. Because their volume exceeded available space in the Postal Inspection Service offices, the records were maintained in a large, specially constructed, locked area of the post office basement.

A major task of the investigation was to acquire a working knowledge of Hutton's cash concentration system and the Federal Reserve and bank check collection systems. A substantial portion of the investigative effort during the first 18 months was devoted to accomplishing these objectives.

A further point should be noted. The original investigative focus was Hutton's activity within the Middle District of Pennsylvania. Until 1984, the investigation did not focus on practices and specific abuses that occurred nationally. The narrow geographic focus of the first half of the investigation was dictated by the original allegations and the venue limitations of federal criminal jurisdiction.

Once it became clear that Hutton's activities were not mere isolated episodes but appeared to reflect a widespread corporate practice, Assistant United States Attorney Murray's objective was to place responsibility for this practice at the highest possible level within Hutton. As a general rule, this strategy led to the pattern of interviewing branch personnel (most of whom sought and obtained immunity), and subsequently certain regional personnel, in an effort to build a case against the members of management responsible for devising and implementing Hutton cash concentration policies. In that regard, it is important to note that vast majority of those who sought and received "immunity" were not criminally culpable in the scheme. Informal immunity is often sought by attorneys representing non-culpable persons in an investigation.

What Hutton Did

In the late 1970's, Hutton had in place a cash concentration or "draw down" system by which the funds collected from its customers at over 400 branch offices throughout the country were moved to bank accounts in New York and Los Angeles, where the funds were available for Hutton's business uses. These customer funds, which amounted to between $200 and $400 million each business day, were first deposited in local bank accounts maintained by each Hutton branch. Hutton advised its branch depository banks were advised by Hutton that these accounts would be used to deposit funds received from the firm's local customers and to transfer these funds to Hutton's regional and prime concentration bank accounts. The local depository banks granted Hutton "next-day" availability on these deposits, that is, on the business day following the deposit of local customers' checks, Hutton would be permitted to withdraw funds in the amount of the deposited items. The branch depository banks believed Hutton would be depositing checks Hutton had received from local Hutton customers, and that the banks would be collecting them on the following business day. Therefore, the banks assumed they would be in a collected position by the time Hutton withdrew the funds.

While Hutton could have transferred its collected or available funds from its hundreds of branch depository accounts to its prime concentration accounts by bank wire transfers, this procedure would have required over 150,000 wire transfers each year at an estimated cost in excess of $1 million. Instead, Hutton "drew down" its branch depository accounts by means of a system which, each business day, required (1) Hutton branch office personnel to determine the collected balance in each branch depository account and telephone that information to the branch's regional office; (2) Hutton regional office personnel to draw checks manually on each branch depository account in their region, deposit the checks in a regional depository account and telephone that information to the firm's cash desk in New York City; and (3) Hutton main office personnel to draw checks on each regional depository account or otherwise direct the transfer of funds from the regional depository accounts to the firm's prime concentration accounts in New York City or Los Angeles. This system, so long as only collected funds were drawn down, was legal.

Hutton's illegal conduct was a series of variations on its established "draw down" system. Hutton modified the legal draw down procedure to withdraw funds from its branch depository accounts in arbitrary amounts well in excess of either customer receipts or the collected balances in those accounts. To do this, Hutton had to "cover" or otherwise conceal the overdrafts it created by depositing into those accounts checks drawn upon other Hutton accounts. These overdrafts, in turn, were hidden from the depository banks by covering checks drafted by Hutton branch personnel and deposited into bank accounts. These checks, available in each Hutton branch office, were drawn upon "zero balance" accounts at one of two New York City banks. By agreement with these banks, Hutton was required to keep no minimum balance but rather was permitted to wire transfer into the accounts, on a daily basis, sufficient funds to cover all checks presented for collection that day.

Furthermore, the covering "zero balance" checks, unlike the local Hutton customer checks which would be collected within one day, took a minimum of two days to clear. Nevertheless, branch depository banks, not realizing that these were not deposits of local customer funds, permitted Hutton to have "next-day" availability on these items as well. Hutton thus exploited the customary bank practice of examining only the ledger balance to determine whether an overdraft exists in an account. As Hutton's branch office personnel were continually depositing Hutton's own checks into the depository accounts, these deposits appeared on the bank's ledgers to balance Hutton's withdrawals. In actuality, because of the minimum one extra day in the collection of a Hutton "zero balance" check, the account was overdrafted for an equivalent period.

Overdrafting was accomplished in a variety of ways, the most blatant being the simple addition of a "zero" to the branch depository transfer check. In this manner, a $100,000 deposit of customers' funds would be arbitrarily increased to $1 million as it was drawn down and a Hutton "zero balance" check in the amount of $900,000 would be deposited in the account to cover the overdraft.

Two specific instances of arbitrary overdrafting, drawn from the Rule 11 proceeding, show dramatically the essence and scope of the Hutton scheme. On November 2, 1981, the Hutton branch office in Williamsport, Pennsylvania deposited $92,475.12 in customer funds in its account at the Northern Central Bank in Williamsport. That day, the amount drawn down from the account into the firm's prime concentration account was $925,000. The difference, $832,524.88, was made up by a check drawn in that amount by Hutton's Williamsport branch office on the firm's zero balance account at Chemical Bank in New York City. This pattern was repeated at the Northern Central Bank throughout November 1981.

On the same day, November 2, 1981, the Hutton branch office in Alexandria, Virginia received customer funds in the amount of $70,629.46 which it deposited in its account at United Virginia Bank. The amount drawn down from the account that day was $9,953,400. The overdraft was covered with a zero balance account check. Between January and December 1981, the Hutton branch in Alexandria received a total of $33,537,397.20 in customer funds and withdrew from its depository account at United Virginia Bank some $640,796,712.08, well over one-half billion dollars in overdrafts. The average daily overdraft at this bank was approximately $9,000,000 in November 1981.

A complimentary, and more pernicious, scheme was the practice of "chaining" whereby Hutton caused funds to be transferred between various branch and regional depository bank accounts prior to deposit in a prime depository account for the purpose of providing additional points for the arbitrary increase of withdrawals and to increase the opportunity for and likelihood of delays in the clearing times of the covering "zero balance" checks.

In the course of the investigation, approximately fifty such "chains" were uncovered which operated in all parts of the country during 1981 and part of 1982. The practices of "chaining" and arbitrary overdrafting occurred principally in 1981. Within several months of the collapse of the Genessee/United Penn kite, those activities were halted.

By overdrafting as much as $250 million per day from its depository accounts, and perpetuating its overdrafts on successive days, Hutton both avoided the necessity to borrow extensive amounts of working capital and earned interest income on surplus funds.

Under one part of the plea agreement, Hutton was enjoined in the §1345 civil injunctive proceeding from engaging in two additional practices not charged in the criminal information.

The first was the use of a "draw down sheet" or formula by which Hutton sought to overdraft its depository bank accounts in an amount which it claimed compensated the firm for the weekend and holiday periods during which funds were unavailable to Hutton. The essence of the draw down sheets was a "multiplier" which increased the amount withdrawn on certain days by a factor of two, three or four.

Hutton's objective in using the draw down sheet and its multiplier was to achieve a "target" or average balance of zero in each of its branch depository bank accounts. To the extent that banks held Hutton funds on weekends or holidays, Hutton recaptured use of that money by precisely calculated overdrafts. While this conduct was not as egregious as the massive, arbitrary overdrafting exemplified by the Williamsport and Alexandria cases, the activity was far more pervasive. Unfortunately, from a criminal prosecutive standpoint, the target balancing technique may be relatively common and was certainly one not considered illegal by Hutton's employees. Without the §1345 civil injunction, the target balance activity would have continued at Hutton.

Another practice was the daily "criss-cross" of checks between two Hutton bank accounts for the purpose of inducing these banks to certify a daily opening balance in each account. Both banks were thereby induced to certify that Hutton had opening balances aggregating substantial sums when the actual aggregate balance was almost zero.

All of these activities--both the practices charged in the information and the activities prohibited in the final judgment of permanent injunction in the civil proceeding--were designed, instituted and promoted by Hutton's money management personnel. The investigation did not develop sufficient evidence to merit the prosecution of any individuals superior to these persons in the Hutton organization.

There are two primary reasons why the money management personnel, rather than senior management, were responsible for these abuses. First, the operations of a brokerage firm such as Hutton are organized into two functional areas: the "front office," which performs all the sales related activities and the "back office," which handles the paperwork generated by the front office and all of the other day-to-day operations of the firm. The registered representatives are the best compensated and are rewarded by promotion to management positions. The back office personnel, who perform the mundane, albeit, in some cases, extremely responsible, tasks are not well compensated and have virtually no opportunity to advance into the senior management levels of a brokerage firm. Senior managers, selected without exception from the ranks of the front office, have neither the experience nor inclination to become involved with back office management. Second, unlike some other major brokerage firms, Hutton's regional and branch operations were effectively "decentralized." Indeed, the regional and branch managers were encouraged to be independent; Hutton closely monitored profit and loss figures for each branch.

It was in this context that Hutton's money managers operated. It was clear from the investigation that they lacked the authority to impose uniform money management procedures throughout the Hutton branch office organization. Although various "draw down" sheets were devised and tinkered with and small meetings and seminars held at irregular intervals to encourage their use, not all branch offices followed the money management office's suggestions. One major reason was that the formula computations required to complete the draw down sheet were complicated and not every branch manager or cashier could do them. Few of the branch cashiers grasped the illegal nature of the activity which the sheets fostered. Furthermore, the evidentiary link between Hutton's money management office and the type of activity found at the Williamsport or Alexandria branch offices was tenuous. Hutton's policy of considering each branch office as an independent profit center led, inexorably, to a sharing with the branch offices of a portion of the interest income being generated by the money management techniques. Some branch office managers, whose compensation was, in part, based upon their office's profitability, were undoubtedly tempted by the opportunities for indirect personal benefit provided by the ability to engage in overdrafting of branch depository accounts. Branch office personnel, however, did not create the scheme and, except for a few instances, did not comprehend its illegality.

Legal Theory and Problems

Check kiting became extremely difficult to prosecute under federal law as a result of the Supreme Court's decision in United States v. Williams, 458 U.S. 279 (1982). The typical check kite case had been prosecuted in the federal system as a violation of 18 U.S.C. §1014. The relevant language is:

> "Whoever knowingly makes any false statement or report, or willfully overvalues any land, property or security, . . . for the purpose of influencing in any way the action of . . . any bank the deposits of which are insured by the Federal deposit Insurance Corporation . . . upon any application, advance, discount, purchase, purchase agreement, repurchase agreement, commitment, or loan, or any change or extension of any of the same, by renewal, deferment of action or otherwise, or the acceptance, release, or substitution or security therefor, shall be fined not more than $5,000 or imprisoned not more than two years, or both."

The theory employed by federal prosecutors was that a kited check was an "overvalued security" or a "false statement." The Supreme Court held, however, that a check does not "make any representations as to the state of petitioner's bank balance," 458 U.S. at 285, nor is it an overvalued security."

The consequence of Williams was to limit drastically federal law enforcement's ability to prosecute check kites. In March 1983, the Department of Justice recommended remedial legislation in the form of a comprehensive bank fraud statute. A year and one half later that statute was adopted as part of the Comprehensive Crime Control Act of 1984 and is codified at 18 U.S.C. §1344. The legislative history makes it clear that §1344 reverses Williams.

Before passage of §1344, the principal alternative to §1014 as a check kite prosecutive vehicle was mail or wire fraud in the limited cases where those statutes applied. In the Third Circuit, however, Williams, took its toll on the "mail fraud/wire fraud" approach to the prosecuting check kites. In United States v. Frankel, 721 F.2d 917 (3rd Cir. 1983) the Court relied on Williams to conclude that a check kite could not be charged under the "false pretenses, representations and promises" clause of 18 U.S.C. §1341 because a check was not a representation. Frankel left open the possibility of a prosecution under the "scheme to defraud" clause, but failed to explain how that could be done. 2/

The net effect of the Williams and Frankel decisions was to eliminate almost completely our ability to prosecute check kites in the Third Circuit. Finding a theory that would not lead to a dismissal under either Williams or Frankel was not simple. The theory that was adopted focused on Hutton misrepresenting its relationship to the banks: Hutton held itself out as creating depository accounts to handle only customer money where in fact the accounts were used to process huge overdraft checks. This is a rather unconventional prosecutive approach to check kiting and turned completely on our ability to establish persuasively that

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2/ The possibility of ITSP (18 U.S.C. §2314) remained, but only as an illusion since that statute requires proof of a fraud. The Williams and Frankel problems led again to the issue of how to define the fraud without relying on the overdraft check as a misrepresentation.

the depository accounts were intended for a highly specific limited use. Obviously, this creative circumvention of Williams and Frankel would have been tested vigorously by a motion to dismiss.

The second legal defense we expected to face was a claim of good faith. Hutton asserted that it had done nothing wrong and was guilty merely of aggressive money management. Hutton also alleged it had merely attempted to "recapture float" that did not belong to the banks. Hutton insisted that its practices were no different than those of other companies.

The third legal attack on our case, available to the individuals who might have been charged, was the simple claim that each was acting pursuant to corporate policy and because Hutton had the means to pay the banks, the requisite mens rea was absent. It is clear that each of the few employees that might have been prosecuted firmly believed his conduct was legal.

The final legal defense was essentially the caveat emptor view that since the banks in fact could observe the transactions, they acquiesced in them.

Process of Evaluation

The Criminal Division was first apprised of the Hutton investigation on March 5, 1984. In April 1984, Fraud Section Chief Robert W. Ogren met in Harrisburg, Pennsylvania with Assistant United States Attorney Murray, Inspector Holland and a number of postal inspectors. The purpose of the meeting was to explore possible theories of prosecution, assess the progress of the investigation, and assess whether staffing of the investigation was adequate.

By mid-summer, it was clear that an additional prosecutor was needed to co-counsel the case, to share the work load with Assistant United States Attorney Murray, to complete the grand jury investigation and to assist in sharpening the focus of the remainder of the investigation. Peter B. Clark of the Fraud Section of the Criminal Division was selected.

Assistant United States Attorney Murray had begun working on a draft indictment in the summer of 1984. The timetable to which the prosecutive team sought to adhere contemplated returning of an indictment in November 1984, shortly before the grand jury's term expired. Thereafter, the grand jury's term was extended for six months to May 1985 to finish the investigation and to permit thorough review of the evidence and theory of prosecution.

Simultaneously with our efforts to complete the investigation late in 1984, the various defense counsel representing Hutton and several targeted individuals sought to make presentations to United States Attorney David Dart Queen in Scranton, Pennsylvania and to the Criminal Division. Mr. Ogren responded to all requests from counsel to meet with Department officials by requiring counsel to present their positions in the first instance to the United States Attorney in Scranton. Several meetings were held in Scranton at which the prospective defendants' positions were set forth. These meetings were held in October and early November.

Counsel for Hutton then requested the opportunity to make written presentations to the Criminal Division and to make an oral presentation to Assistant Attorney General Stephen S. Trott. We agreed to review Hutton's written position and prescribed a timetable for written submissions. The written submissions, which were voluminous, were reviewed in detail. We subsequently agreed to meet with counsel and the oral presentation was scheduled and held on January 7, 1985. [3]

In mid-January 1985, in Harrisburg, Fraud Section Chief Ogren reviewed the evidence against Hutton with Messrs. Murray, Clark and Holland. [4] The purpose of this review was to provide a recommendation to Assistant Attorney General Trott for or against indictment of Hutton. This review led to the conclusion that criminal charges for mail and wire fraud could be brought against Hutton if the theory of prosecution was narrowly focused on the grossly excessive overdrafts and the phenomena of overdraft "chains." It was also clear that the evidence might support charging some individuals but review of that issue was temporarily deferred. Meanwhile, Mr. Ogren requested Messrs. Murray and Clark and the Postal team to develop evidence of additional chains as a priority matter. Fraud Section Chief

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[3] Attending were Trott, Deputy Assistant Attorney General Victoria Toensing, Ogren, Clark, Murray, Holland and Supervising Postal Inspector Thomas Dagley, plus counsel for Hutton.

[4] In January 1985, United States Attorney Queen resigned his office and the Fraud Section of the Criminal Division, which had been assisting in the investigation, assumed direct supervision of the matter.

Ogren reported his conclusions and recommendations to Mr. Trott, who in turn asked Mr. Ogren to advise Hutton's counsel that he had made a decision to proceed to indict. Mr. Ogren advised Hutton's counsel of Mr. Trott's decision.

Two weeks later, in Harrisburg, Messrs. Ogren, Murray, Clark and Holland conducted an intensive review of the evidence against target individuals. The preliminary assessment was that we had sufficient evidence to proceed against two Hutton employees. The tentative conclusion was also reached that additional evidence would be required before any other individuals could be added to the list of probable defendants. Counsel for the employees were advised of our decision and in turn they sought to make presentations on their clients' behalf. Meetings with these counsel took place in February 1985. 5/

Assessment of Risks of Trial

A major component of the judgmental equation was the risk faced in litigating the criminal case with two or more individuals joined as defendants.

An indictment would have resembled the information, but would have been limited to counts involving jurisdictional uses only in the Middle District of Pennsylvania. The focus of an indicted case would have been on two types of check abuses: the arbitrary overdrafts exemplified by the Williamsport and

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5/ Attending for the government were Messrs. Ogren, Clark, Murray and Holland.

Alexandria situations and branch-to-branch chains exemplified by the Genessee/United Penn kite. In order to demonstrate the breadth and significance of the scheme we expected to prove six or more arbitrary overdraft situations and at least twenty chains.

The scope and complexity a potential trial was unprecedented. Of the 7,000,000 documents subpoenaed by the grand jury, our estimate is that several hundred thousand would have been needed at trial. The number of authenticating witnesses alone would have exceeded 200.

Several hundred descriptive charts would have been required. Approximately 20 charts were prepared for use in the Rule 11 proceeding simply to explain the theory of the government's case to Chief Judge Nealon.

In addition to hundreds of authenticating witnesses, we would have presented over one hundred fact witnesses and a number of experts.

Pretrial discovery in this case would have taken months.

Although the case management problems of the prosecution were enormous, and the expense of the litigation would have been considerable, other factors were of greater importance.

Put bluntly, this case was not a sure winner against individuals. The probable legal defenses mentioned above were not weak. In addition, there were a number of serious practical problems. The most significant:

- The prospective individual defendants did not gain personally from their offenses. This defense has historically been an effective one with juries. Our most recent example is the acquittal on May 10, 1985, of George McLean, a former International Harvester employee, in the Pemex FCPA prosecution.

- The banks in many instances should have uncovered the fraud. It could appear they had turned their heads to avoid discovering it (in which case it would have been argued that it was not a fraud).
- We recognized that two attitude factors might contribute to jury nullification: one might best be described as a "to hell with the banks" attitude; the second, the "there but for the grace of God go I" attitude reflecting the reality that, at one time or another, most jurors have overdrawn their accounts. These two attitudes, coupled with a defendant's demonstrable ability to pay, have historically made check kite and bad check cases extremely difficult to prosecute successfully.
- Severance problems. In all likelihood, one individual defendant would have been entitled to a severance. Thus the case would have been tried twice.
- Confusion. Although, we believe the clarification of the theory of prosecution and limitation of the proof to arbitrary overdrafts and chains was constructive, the government's evidence was complex and difficult to understand. It is noteworthy that after several weeks of our providing detailed briefings and answering questions for Congress and the Press, only a handful of the

reporters and political figures who have written or commented on the case appear to have any idea what the case is about. Many simply still do not understand the facts.

Our final assessment was that at trial we would probably prevail against the Company. Our prospect to prevail in a trial against specific individuals was considerably less certain.

Evaluation of Negotiations

A major objective of the prosecution was not only to bring an immediate halt to Hutton's money management abuses, but also to make the case a landmark that would establish specific standards of practice for money management. This second objective was linked to our assessment that Hutton's practices, if replicated by financially precarious companies, had tremendous potential for harming banks, particularly the smaller, more vulnerable banks.

At the time we commenced plea negotiations with Hutton, we had assessed our prospects of success in an indictment and trial along the lines discussed above. Essentially, the maximum we could realistically obtain through litigation was the following:

*Indictment and conviction of the Hutton brokerage subsidiary and possibly its parent, Hutton Group, on approximately 500 mail and wire fraud counts each (the maximum as to which we had venue in the Middle District of Pennsylvania) with a maximum aggregate fine of

$1,000,000.

- No recovery of the costs of investigation, but recovery of some costs of prosecution.
- Restitution, but possibly limited only to bank victims in the Middle District of Pennsylvania. Restitution would have to await exhaustion of all appeals.
- Injunctive relief against Hutton for ongoing practices could not be obtained during the pendency of the criminal case because a contemporaneous civil proceeding would have created difficult parallel proceeding problems.
- Prosecution and conviction of the only individuals against whom there was sufficient evidence to indict and possible imprisonment. However, because they had not personally profited from the offenses, the likelihood that either would be imprisoned was low, assuming that convictions were obtained.

These objectives could only have been obtained via an extraordinarily lengthy, complex and chancy trial.

The results achievable by plea disposition, on the other hand, were clearly far superior. The issue was simply whether the prosecution of two mid-level individuals, who had not personally gained from the fraud, was of sufficient importance that it warranted accepting the enormous litigation cost and risks that a trial would require rather than the immediate and dramatic benefits provided by the terms of the disposition. Our assessment was that the terms of the plea bargain accomplished such a high percentage of our enforcement goals that it should be accepted.

The Criminal Division policy regarding the prosecution of corporate officials and employees for acts of wrongdoing is that corporations act through individuals and, therefore, individuals must be held accountable for corporate actions. That policy, when placed beside the facts, uncertainties and legal ambiguities of this case, would, if inflexibly applied, have forced us to reject a plea agreement that in many significant ways accomplished more than we could have achieved by a trial. In addition, it would have saddled us with a trial of unprecedented difficulty and high risk. That policy, however, is an important one and is sacrificed only when there is an overriding interest in doing so. The benefits derived from the Hutton plea were so substantial that they clearly warranted an exception to our policy.

The judgment in this case was most heavily influenced by two factors: first, Messrs. Murray, Clark, and Ogren viewed it as absolutely essential to obtain an injunction that barred the full range of Hutton's overdraft practices including the use of the draw down sheet and its multiplier. Hutton had made clear to us its intent to continue its draw down practices involving the use of the multiplier without disclosure to its banks. Hutton further indicated that it was computerizing the process to make it more efficient and uniform throughout the firm's operations. Second, the practices Hutton employed are believed to be wide spread and to cause large interest losses to banks, which posed the threat to inflict huge losses on banks if the overdrawing broker or business failed. Because of Williams, and under the facts of this case, these practices could not be reached by an indictment. However, an injunction, based on the bank fraud statute that overruled Williams, would provide a visible enforcement vehicle.

We ultimately viewed our choice as one between an uncertain prospect of convicting two mid-level individuals who did not gain from the fraud against the certainty of a broad based enforcement stroke that could immediately wipe out cash management abuses throughout the business community.

Conclusion

Based on the foregoing assessment, Messrs. Ogren, Clark and Murray recommended that the plea bargain reflected in Plea Agreement filed with the Court be approved. The key elements of the disposition are:

1. Hutton guilty plea to 2,000 Counts of mail and wire fraud. Fine of $2,000,000 (the legal maximum).
2. Hutton payment of $750,000 in investigative costs (not otherwise recoverable).
3. Hutton make full restitution, plus interest.
4. Hutton take a series of actions to inform and educate its employees in order to prevent a recurrence of abuses.
5. Hutton consent to an injunction that prohibits arbitrary overdrafting, chaining, use of multiplier or formula, ceiling-crossing and requires full disclosure of its cash concentration practices to its banks.

The disposition was approved by Assistant Attorney General Trott. Following action by Hutton's Board of Directors, Hutton entered its guilty plea and consent to the injunction before Chief Judge Nealon on May 2, 1985.

Mr. HUGHES. Thank you very much, Mr. Trott.

If it is agreeable with my colleagues, the matter is an extremely complex matter and it is very difficult to develop a rational line of questioning in 5 minutes. My inclination would be to go to 10 minutes, if that is agreeable, and really stick with the 10 minutes. When the 10 minutes is up, I will indicate to counsel and the witness, and the witness can finish the answer and go to the next question. Perhaps we can get over the material with a little more continuity than has been in evidence in some of the other hearings. So if that is agreeable, that is what we will do today.

First I want to thank the witnesses for being with us this morning. I quite agree with you, I think it is probably one of the most complex cases that I have seen also. I am sure that there have been more complex cases, but this certainly was an extremely complex case, and represented a great deal of legwork in developing the case. As I have said, I think that the U.S. attorney, Al Murray, who handled the case, and John Holland, who was the lead investigator, did an excellent job of developing a very difficult case.

I think we all know at this point what the questions are that arise, and I have indicated to you many times, and I repeated it at the last hearing, prosecutors have to make decisions sometimes, based upon how they look at a case, as to what is in the interests of justice. Sometimes you have to take less than you would like, because of certain weaknesses in a case, or sometimes you want to proceed against somebody else who is more important, and you let somebody else plead to an indictment or information that is less severe than is warranted, because the interests of justice are better served by that, and I am not going to put myself in a position, nor would I want this committee, to second-guess a prosecutor's judgment call, if there is a reasonable basis for it.

The difficulty is that during the process of handling the negotiations in this case, either indicting, if in fact a plea arrangement would not be arrived at, or in the event a plea arrangement was arrived at, certain things occurred that raise some serious questions. I am talking particularly about a luncheon that took place on November 15, 1984, which was during this critical time period, when the grand jury was extended. Supervision of the case was also moved, during this same general time period, to Washington, again raising additional questions, since the matter was being handled ably by the assistant U.S. attorney in the middle district of Pennsylvania.

There are some documents that have surfaced that would appear to be at variance with some of the testimony that we heard from the assistant U.S. attorney last week, insofar as the actual handling of the case and the handling of the negotiations, and it is those issues that I hope that we can focus in on today.

As I have indicated, after we have focused in on those issues, then we can get to the question of documents that we feel have not been produced that are essential for us to complete our investigation of the case.

First I wonder if you can tell us, Mr. Trott—you are fairly conversant with the case—what is the essence of the case against E.F. Hutton?

Mr. TROTT. I suppose the best thing that I could do to answer that question, Mr. Chairman, is to incorporate by reference everything Mr. Murray said last week. To simply tell you that E.F. Hutton in our view engaged in an aggressive cash management system that went over the line, and in effect figured out a way to relieve banks of short-term unsecured loans without their knowledge. They managed to create the appearance of money really where there was none, and to use that for the purpose of making, of utilizing interest on that money at the expense of the banking system.

Mr. HUGHES. Who was wronged by the violation of our criminal statutes, with regard to E.F. Hutton?

Mr. TROTT. We think, essentially, some banks were victimized by this, and the entire banking system was placed at risk, as Mr. Murray explained last week, by this scheme.

Mr. HUGHES. When you say at risk, you are talking about if the scheme had become industry practice, it would put it at risk, or what were you referring to?

Mr. TROTT. Well, the way I looked at it——

Mr. HUGHES. The banking industry is a pretty broad industry.

Mr. TROTT. That is true, but at the time, it is my view that if E.F. Hutton had failed during the time all this bad paper was out, the people who would have been left holding the bag would have been the small banks, and that doesn't mean a bunch of brick buildings either. It means a bunch of depositors.

I think we have seen enough situations in this country in the last year with people standing outside banks and savings and loans trying to get inside to get their money to know that any practice that has the capacity to affect the integrity of our banking and savings and loan institutions ought to be of serious concern to the United States. And it was our view that had Hutton failed or if other companies engaged in these kinds of practices that it could have been a situation that could have caused a lot of trouble for banks.

There have been a number of articles about overdrafting. There was one in the Washington Post that was reprinted in the national weekly edition on page 21 on July 8, 1985. It starts out and says:

> It is the ultimate financial nightmare at the end of the business day a major bank does not have the funds it needs to make good on the hundreds or thousands of payments it made that day to other major banks over one or another of the nation's electronic fund transfer networks. Another bank counting on receiving money from the defaulting bank finds itself unable to meet its obligations. It then defaults and triggers a default at yet another institution. Defaults cascade. The U.S. banking system collapses.

Now, I am not trying to sit here and tell you that this placed in jeopardy the entire financial system of the United States, but to indicate that Al Murray and John Holland discovered a plan that nobody even knew was there, cash management, and they discovered that it was rife with abuses that in our view placed in jeopardy the financial soundness of many of our institutions, financial institutions, and that was one of our main focuses in the handling of this case.

Mr. HUGHES. What was actually taken from the banks and the Federal Reserve System, which obviously was victimized as well, and in turn the American taxpayer? What was actually taken by E.F. Hutton as part of its scheme to defraud?

Mr. TROTT. I suppose the best way to boil that down into a short answer is interest that was unearned and undue.

Mr. HUGHES. Did they ever intend to pay that back?

Mr. TROTT. Pay back the interest?

Mr. HUGHES. Yes.

Mr. TROTT. I certainly don't think so.

Mr. HUGHES. E.F. Hutton indicated they always intended to pay back, but the point is they never intended to pay back the interest to the banks.

Mr. TROTT. It doesn't appear that they did.

Mr. HUGHES. What were the elements that Justice would have to establish to make out mail and wire fraud violations by E.F. Hutton?

Mr. TROTT. The statutes pretty much speak for themselves, Mr. Chairman. The difficulty, of course, with the *Williams* and *Frankel* case, the necessity that our lawyers felt to go beyond regular check kiting and find a scheme to defraud that contained other elements than just mail and wire fraud. Up until the amendment of the bank fraud statute in 1984, we had a serious legal complication on our hands.

Mr. HUGHES. What was the requisite intent that had to be established by the Department of Justice to establish this case?

Mr. TROTT. I think Mr. Ogren is probably better able to answer that than I am, with your permission, Mr. Chairman.

Mr. HUGHES. Mr. Ogren.

Mr. OGREN. Mr. Chairman, under the mail fraud statute, there are clearly three elements. You have to prove the existence of a scheme or artifice to defraud, to obtain money or property by means of false or fraudulent pretenses. That is element No. 1. The second, you have to prove a jurisdictional use that furthers the execution of the scheme, either a wire use interstate or a mailing that complies with the statute. And the requisite intent element in that is that you have to show an intent to defraud.

Mr. HUGHES. And what is adequate to prove the intent to defraud, the latter category? What is the essential proof to establish the intent to defraud?

Mr. OGREN. Well, it varies from case to case but in this case what you would have to show is first of all you would have to fit in with the statute, that is to say that you had to show that there was a misrepresentation, and then you have to show that the individual or the company, as represented through its agents, had knowledge of the misrepresentation, intended the misrepresentation to be made and sought the objective of the scheme.

Mr. HUGHES. Do you have to show knowledge that it violates the law?

Mr. OGREN. Knowledge that it violates?

Mr. HUGHES. Violates the law.

Mr. OGREN. The law? In proving intent to defraud, where you are dealing with industry practices, you have to—what you have to do is, you have to prove nongood faith. Good faith is a defense. Industry practices would amount to a good-faith defense. If one were to take a look at practices in the industry as a guidepiece, and pretty much blow away the possibility of a conviction in terms of, do you have to know that this is a mail fraud? Do you have to know that this is a violation of the mail fraud statute? No.

You have to know that you are telling a lie that the law recognizes as a lie, and you have to also not be operating in good faith, and the problem here ultimately—we are getting to ultimate questions in a way—the problem here is the good-faith element that is preserved by the industry practices. That fairly well demolishes a criminal theory.

Mr. HUGHES. Is there any evidence at all that what E.F. Hutton was doing represented industry practice at any time?

Mr. OGREN. Insofar as the daylight overdrafting, we are getting into—you see, when you asked Mr. Trott the question of whether or not—what was their scheme, their scheme was to obtain interest-free money, no doubt about it. But they did it in a variety of different ways, and each one of those is a subscheme. And I think we have to break out whether or not they complied with industry practice or didn't. If you take the excessive overdrafting, and if you take the chaining, no way that is industry practice.

Mr. HUGHES. Isn't it true, Mr. Ogren, that the company seemed to go through a transition, evolution, first with the drawdown sheet that had a certain calculated amount that could be drawn down by the branches, and then a discovery that by prolonging that, you could create a little more float, by chaining, and the float could be maximized subsequently by drawing down much more aggressively than the drawdown sheets permitted, to finally in some branches an absolute just ignoring the drawdown sheet? There seemed to be a transition?

Mr. OGREN. That is correct. It was an evolution from the drawdown sheet that had been in existence in the seventies to the testing for float, the creation of the chaining in the excessive overdrafting that began in 1980.

Mr. HUGHES. So it is safe to say that while it might be industry practice to maximize float, that banks had knowledge that corporations draw on uncollected funds, it would not be industry practice to deposit $70,000 and drawdown $7 million?

Mr. OGREN. That is correct.

Mr. HUGHES. And in your investigation you found no other firms that used such techniques?

Mr. OGREN. Well, I can't speak to what the investigation found. Mr. Murray was the one who conducted that aspect of it.

Mr. HUGHES. Was your department aware of any other firms that were using such aggressive excessive overdrafting?

Mr. OGREN. Sir, what do you mean by excessive overdrafting? Are you talking about the chains and——

Mr. HUGHES. I am talking about chaining and overdrafting 5 and 6 times, 10 times, 25 times what was being deposited.

Mr. OGREN [continuing]. I am not aware of any but I can't—Mr. Murray may know. I am not aware of any.

Mr. HUGHES. Were you aware of any firms that as a matter of practice or policy provided checkbooks on various banks around the country to the branch banks to create an overdrafting scheme as you found at E.F. Hutton?

Mr. OGREN. I don't know that anybody investigated any other company, Mr. Chairman, so I don't know that that is a particularly helpful question.

Mr. TROTT. Mr. Chairman, what we do know—and we have some of the documents that are put out by journals on this—that cash management is a science. It is practiced by many companies, and what we did discover in the Hutton case was something that may start out generally within the realm of accepted industry practice that is probably legal, can be converted and perverted very quickly by people as they become overly aggressive and involved in it.

Mr. HUGHES. Is it fair to characterize this as cash management, when in fact there became very little relationship between the cash being managed and the amount being created by way of float?

Mr. OGREN. That is right. That is why it was criminal.

Mr. TROTT. It is a euphemism, I guess, to continue to call it cash management.

Mr. HUGHES. That is my point.

Mr. OGREN. That is right.

Mr. HUGHES. It was not cash management as the business community knows cash management?

Mr. TROTT. It is almost like a movie scene that starts out in one area and it slowly fades over like a lapse into something else, and that is the evolution that you referred to accurately in your description of how it started out one way and slowly was perverted and over time became something else, and there is probably a gray area in there when it was crossing over, and many of the theories that we had sort of found in that gray area until finally it got over into clearly overdrafting and into chaining and it was at that point that the team felt we had a solid theory that did establish criminal conduct on the part of E.F. Hutton.

Mr. HUGHES. My time has expired. The gentleman from Florida.

Mr. MCCOLLUM. Thank you. I want to welcome the witnesses today.

I must say you have a tough act to follow with assistant U.S. attorney, Al Murray, who gave quite a testimony last week. I want to summarize to see if we can get at the guts of Justice's handling on this matter as we focus on the last set of hearings. It seems to me that the key issue is the decision not to prosecute individuals, and the judgment call, whether it is second-guessing or whether it is analytically looking at the background as to whether there were any influences that perhaps shouldn't have been present making those decisions. And to me that is the key question, when you really get down to it, because we can be here second-guessing that judgment all day, but I am concerned that there were no undue influences in that decision process.

Before I ask questions about that aspect, I would like to make sure that I fully understand, as I think I do from Al Murray's testimony, and all we have heard up until now, the key thought processes that guided the Justice decision not to prosecute individuals in this case. And if I can summarize from my notes, I am going to ask, Mr. Trott, if you can corroborate for me that I am correct in this as the key element assessment. First of all, if individuals had been tried, prosecuted in this case, it would have taken years to complete the case at considerable cost to the Government and the taxpayers.

Second, any conviction of those individuals was a very uncertain thing, because there was not particularly good law. The two cases or three cases that you have cited to us took away a lot of the tools for prosecuting this type and left you with only one fairly untested route in the mail fraud area to prosecute.

Also the proof itself would have been difficult. The enormous volume of paperwork involved and the conflicting testimony that was inevitably going to come about, and then there were the defenses that could have been argued reasonably to a jury, to a court, that were going to be made by the Hutton folks with regard to the fact that they did not have in essence the mens rea, the intent that was involved, at least that is what they would have gone to.

Last, it seems to me that you have given us the benefit to the public argument for the settlement that ultimately was reached instead of prosecuting, the benefit in the sense of being able to take off the system of cash management, remove a lot of the policies not only of E.F. Hutton but of many other companies in this country who were abusing the system but not have technically been in violation of the existing laws, plus the restitution and obviously the fines.

Now, have I summarized correctly the basic rationale of this settlement or am I omitting some major part of the rationale?

Mr. **Trott**. You have generally described it, but I would like to add specifically the use of the injunction which Congress gave us for the first time in 1984. It was our view that the injunction was the message that was being sent to corporate America and to cash managers all over, that for the first time drew a bright light in this area and said generally here is what we think is acceptable and here is what is not acceptable. When I talked to Bob and Al and Peter, they were very adamant that the injunction, the terms that we dictated, was an extremely important part of the settlement of this case.

You are correct. After many discussions, we determined that the benefits that could be obtained for the Government and for the banking system and for the people of America and for the specific victims far outweighed the risks of going to trial.

Mr. **McCollum**. Just who made this decision to make this settlement, and how was it arrived at?

Mr. **Trott**. The decision was made in the first instance by the trial team, Mr. Murray, Mr. Clark, and Mr. Ogren. After they hammered that out, they came and discussed it with me.

After discussing it with them for a lengthly period of time, I came to the conclusion that it was a case, or first impression, and it was an appropriate case to not use our normal policies, which is to prosecute both the corporation involved and the individuals inside the corporation.

Mr. **McCollum**. Is it true that initially you resisted the argument that they made to you not to prosecute the individuals?

Mr. **Trott**. Yes. But maybe Mr. Ogren is better able to answer that than I am, because it may sound self-serving coming from me.

With your permission, I will let him describe it.

Mr. **McCollum**. I will be glad to let Mr. Ogren answer that.

How did it happen?

Mr. OGREN. He was a hard sell, is what it boiled down to.

It was very difficult to persuade Mr. Trott on the merits of what ultimately became the disposition in this case. Mr. Murray and I and Mr. Clark were fully convinced that what needed to be done was to stop not just chains and the excessive overdrafting. That had been, in effect, more or less stopped on its own.

But to stop the evils, as it were, of the drawdown sheet, the multiplier, the crisscrossing of checks, the daylight overdrafting problem that Mr. Trott referred to, and the only way we were going to be able to do that was by some kind of complusory order.

Hutton had made very clear that they intended to continue this practice. We believed that they were in violation of the banking fraud statute, not the mail and wire fraud statute in the light of the *Frankel* and *Williams* cases, but because the banking fraud statute had been enacted in a climate to reverse the *Williams* case.

And that was our objective when we sent it up here and when Congress enacted it we believe the banking fraud statute reached and reversed the *Williams* case, and reached the excessive—excuse me—the drawdown circumstances that drawdown sheet——

Mr. MCCOLLUM. But that was going to be hard to prove, wasn't it; very hard to prove?

Mr. OGREN [continuing]. It was very hard to prove. We felt we could obtain this in a settlement, an injunction, a binding agreement that was court ordered, we would have a big win for the United States.

Mr. MCCOLLUM. When did you reach this recommendation point where you, and Al Murray, and Mr. Clark, and everybody agreed to take this to Stephen Trott?

When did you reach it?

Mr. OGREN. We took it in two stages. We took it after our initial round of negotiations with the other side, and that would be about the end of March.

Mr. MCCOLLUM. Of this year?

Mr. OGREN. Yes, in March 1985, after we had had an initial round of discussions, and the possibility of getting the injunction was there. The possibility of not proving against individuals was there; and it was more or less that along with several other factors for the kind of equation.

We started talking to Mr. Trott to say, look, we don't know what the final package will be. We have got to negotiate it out.

Tell us today if this is out of the question, in your mind. And we talked about it at great length. He was hesitant.

He was reluctant, but he finally gave us the go ahead to continue the negotiations and look at the final package.

Mr. MCCOLLUM. My time is relatively limited. I know I still have some left, but I want to cover very quickly some things and I am sure you will be asked much more in depth about all of these.

To what degree, Mr. Ogren, did Al Murray make the recommendations initially?

To what degree was this a decision that you encouraged. It was a mixed product. How did this come about?

Mr. OGREN. Most of the ideas that are embodied in the final settlement were Al's. There are some particular slants to them that I think Peter and I put on them.

But it is hard sometimes to attribute who has the responsibility for fathering a particular idea. But Al was responsible for many of them. We kicked them around, and they eventually became the ideas.

Mr. MCCOLLUM. Let me jump into here. It appears that first there was a decision to extend the grand jury and then there was a decision on how long to extend the grand jury.

Who made the decision to extend the grand jury, and when was this decision made?

Can one or all three of you answer that?

Mr. OGREN. It was made, but I can't tell you—I don't think any specific person made it. I think it was——

Mr. MCCOLLUM. When was it made?

Mr. OGREN [continuing]. It was made by November 13.

Mr. MCCOLLUM. Where was it made?

Mr. OGREN. Well, it would have been by phone. Peter, Al, myself, possibly involving Dave Queen in the conversation. I may have talked to Mr. Trott about it, but it was the consensus that that was the thing to do.

Mr. MCCOLLUM. When did the meeting that is so well publicized now occur between Mr. Fomon and the Attorney General, the luncheon occasion.

Does anybody remember the date of that?

Mr. TROTT. We are all told it was the 15th. None of us, of course, were there.

Mr. MCCOLLUM. When did you first learn of it, Mr. Trott?

Mr. TROTT. I am not absolutely clear on that. I have gone back with Mr. Gregory, and staff present, trying to consult my phone logs and everything else. As best as I can tell you, it was some time after the luncheon.

I don't know what it was the 15th or the 16th, or when. I know that I had some telephone conversations apparently on the 21st with a man named Mr. Moorhead, and with Tex Lazarus, about that luncheon, but I found out about the luncheon only some time after it happened.

Mr. MCCOLLUM. Did the luncheon meeting or the fact that it occurred or anything that came out of it have any influence on the decision to extend this grand jury or the ultimate settlement decision of this case, Mr. Trott?

Mr. TROTT. Absolutely none at all. It was a nonevent as far as the substantive handling of this case, a complete nonevent.

I may add I may have been a hard sell but after Bob and the team explained to me the benefits of the settlement I became a believer, and I remain a believer that the settlement was in the best interests of what we were trying to accomplish.

Mr. HUGHES. The Chair recognizes the gentleman from Connecticut for 10 minutes.

Mr. MORRISON. Thank you, Mr. Chairman.

I will direct this question to you, Mr. Trott; but if Mr. Ogren is more appropriate to answer it I will be happy to have one or both of you answer it.

With respect to the decision not to proceed against individuals, and to accept a plea agreement covering only the corporation, where did the demand first come from, or the request or the approval first come from, to decide to do both of those things?

Mr. TROTT. You clearly could accept a plea agreement from the corporation without making a deal with respect to the individuals. Who first asked that you make that a package if anyone——

Mr. OGREN. It arose during the course of our opening discussions, opening negotiations with defense counsel. Once we had reached the point to which we decided to proceed with the case criminally, we were satisfied that we had the evidence and we had a theory that would fly.

We told counsel on the other side that, and we said if you want to open discussions with us about a possible disposition before the case is charged, feel free to do so.

This is common in criminal cases, and they said, yes. They came down and we talked and it was during the initial discussions that they pressed for that position.

Mr. MORRISON. When you opened negotiations, did you open negotiations jointly with counsel for the corporation and counsel for individual targets?

Mr. OGREN. No. It was corporation counsel only.

Mr. MORRISON. Did all your negotiations involve only corporation counsel?

Mr. OGREN. That is correct.

Mr. MORRISON. So, you never negotiated with individual counsel?

Mr. OGREN. That is correct.

Mr. MORRISON. So, in no way did you negotiate with individual counsel about excusing individuals?

Mr. OGREN. That is correct.

Mr. TROTT. Mr. Morrison, I may add that I was not at these meetings, which is why Mr. Ogren is answering the questions. He and the trial team negotiated the settlement that was brought to me later.

Mr. MORRISON. And why was it that you negotiated with corporate counsel about the fate of individuals?

Mr. OGREN. Well, that happens in cases like this, if that is an issue. The first line of negotiations, if they were to be successful, was going to be with the corporation.

If we had hit a rock in these negotiations on the issue, and that was an unacceptable position as far as we were concerned, we would have then opened up negotiations with the individuals, and they would have probably told us to go to hell, and then we would have ended up trying the case; but that is not what happened.

Mr. MORRISON. I want to back up. I still don't understand in what posture and why it arose, that in your negotiations with the corporation over the fate of the corporation in a potential indictment of the corporation you were open to and you decided to make a decision about individuals.

I guess to get more specific, at what time and in what way were you requested to do that?

Was it in writing?

Was it oral?

Who was it by?

When did it occur?

Mr. **Ogren**. It occurred during the first negotiations.

Mr. **Morrison**. Can you give me a time.

Mr. **Ogren**. I can't give you a precise date. It would have been around March 20, 21, 22. Counsel for the company was present.

I have never regarded—if the decision is that it will be a nonprosecution decision, in effect, a declination against individuals; that is something that is raised from time to time by corporations.

We have never taken a position at the Department of Justice or in any of the U.S. attorney's offices that I am aware of that that issue will not as a threshold matter be addressed properly by corporate counsel.

If we had had problems with that, and then they were in a position, in effect, of negotiating a substantive position that would damage those individuals, then we would not have gone forward, but this could not have worked to the harm of any of the individuals involved, so it was not necessary for their counsel to be present.

Mr. **Morrison**. I am not really asking the question of when they were adequately represented in the process, since I agree that they got off, so they could hardly complain.

I am really asking the question, and I still don't think I have a clear answer; this was raised by corporate counsel?

Mr. **Ogren**. Yes.

Mr. **Morrison**. Are you saying it was raised in these meetings in March?

Mr. **Ogren**. Yes.

Mr. **Morrison**. Had you, prior to those decisions, those discussions in March—what was your intention with respect to target individuals?

Were you intending to indict individuals at that point or not?

Mr. **Ogren**. Well, we had gone through what might roughly be described as a case evaluation process, and Peter Clark, and I had spent time in Harrisburg evaluating the evidence. We did that on two separate occasions and Peter, of course, was much more heavily involved in the actual handling of the case.

We went through the case, and we determined that we had sufficient evidence to bring charges relating to the excessive overdrafting of the Williams' type situation, the Alexandria type situation, and we had sufficient evidence to bring charges with respect to the chains.

We also believed—as to the company, and we believed with respect to both of those activities that we had enough to charge two individuals.

At that point we still had an open mind about several others. We weren't ruling it out, but we hadn't reached—we communicate that to counsel, that we had done our own——

Mr. **Morrison**. When you say communicated to counsel it really would be useful since there are a number of counsel running around. Who are these targets if you would identify when you say counsel if you mean corporate or counsel for individuals.

Mr. **Clark**. Mr. Ogren is referring to counsel for the two individuals with respect to whom we made a recommendation.

Mr. **Ogren**. And counsel for the corporation.

Mr. Clark. And the company.

Mr. Morrison. So you did at the time that these negotiations commenced, had determined that you had the goods on two individuals, and according to Mr. Holland's memo, which was introduced into evidence at the last hearing, he reports that you had said there were grounds to indict individuals; so at that point was it your intention to proceed against individuals?

Mr. Ogren. Unless we had successful negotiations with respect to a disposition, is that we could obtain by negotiation results that were otherwise unobtainable; yes, we would have returned an indictment.

Mr. Morrison. What did E.F. Hutton offer to you, give you, or say to you that caused you to think—caused you to decide not to indict individuals. In other words, you are saying that up until March you were ready to indict individuals.

Then you had negotiations with E.F. Hutton and it was Hutton's request that caused you to drop it. What precisely did they offer to you in exchange for letting individuals off?

Mr. Ogren. It wasn't fully just for letting individuals off. It was for the whole package, but the key—ranking them in order of importance, what they gave us was the injunction, uncontested, that stopped dead in the tracks a fraud that had only been made illegal by Congress in October 1983. That was being stopped dead in its tracks.

The money management community was going to know, the cash management community was going to know, on the day that that injunction became effective, that this was illegal, and it had to stop, and that is exactly what has happened.

It is going to give us an immediate presence in cash management. We would not have gotten that otherwise.

Mr. Morrison. That explains your accepting the settlement as a whole; and I am asking you to what extent, who made the decision on individuals, a critical part, and how that became a critical part, of reaching the settlement?

You certainly could have said in response to an offer to plead that we will take your offer, here is what we will do, and the individuals stand aside, we are not going to settle that matter.

Why did you do that?

Mr. Ogren. Corporate counsel indicated to us that the issue of individuals was a deal breaker.

Mr. Morrison. And how did they indicate that, orally or in writing?

Mr. Clark. By saying so.

Mr. Ogren. Orally.

Mr. Trott. Mr. Morrison, just so it is absolutely clear, as I understand it, we did have the ability to prosecute, and, indeed, two individuals along with the company at the point at which we found ourselves. In negotiations with Hutton, it became absolutely clear that disposition that was eventually taken, the terms of which we dedicated, was available, but not if we were going to go ahead and prosecute these individuals, so we were faced with a judgment call.

Do we take a package that to us was unattractive, prosecuting the case including two individuals, or the other package, which you know all about now; and that was the unanimous judgment of the trial team, which I ratified, and which I still believe today was a good result that we ought to do that, and so we did make a call and we decided that what we got was better than chasing two individuals in Pennsylvania.

Mr. MORRISON. So, your testimony is that Hutton demanded it as a condition of the plea agreement, and you accepted it, and it was their initiative, and their demand that caused you to make that decision.

Mr. OGREN. It was there—it was a deal breaker. Absent that, they would have gone, the matter would have gone to trial, we would not have had the injunction. That was our price.

Mr. TROTT. And we were certainly free to reject that; but when Bob came in, and we talked about this, I wanted to know what we were getting in return for giving up the opportunity to both prosecute Hutton and these particular individuals. I wanted to know what balanced out on the positive side of the scale for our side of the team; and when Bob explained the use of the injunction, which I think was marvelously done, the cost of the investigation which would not have been available if we had gone ahead and prosecuted the case, the most aggressive and innovative victim restitution plan you will find anywhere in a white-collar case.

Usually victims are left until the end and then we pick up the pieces. This picked up all of the victims. We were going to set up a master.

The banks were going to get paid back with interest. We were going to sit down and help the banks figure out how they had been screwed around by this. Two thousand counts.

I told them under no circumstances a nolo plea. This will have to be a guilty plea. When we totaled up all the things that were on the plus side of the equation, and when we scooped out what a prosecution in Pennsylvania would have looked like that could not even have included all of these victims, that is when we came to the conclusion that chasing the two individuals in the company almost would have been negligible in view of what we had right there in our grasp at that time.

It was at that juncture that I agreed—Bob Ogren is a career prosecutor; he has been in this business for 17 years. This man knows more about fraud cases, I venture, than anybody.

He has a universal and a global scope on these things.

Peter has an SEC background. He understands these things inside out.

You saw Al Murray, and I don't have to describe him to you. Confronted with a collective judgment of these three individuals, the judgment call clearly came down on the side of the settlement.

After looking at it, I said it is right, we will forego the opportunities to chase these individuals.

Mr. HUGHES. The time has expired.

Mr. TROTT. If I may just add 30 seconds; prosecuting individuals in these cases is extremely complex. If you will look into the tail end of the General Electric case which we just finished up in Philadelphia, you will find acquittals of two of the individuals that were involved, and they eventually came in and gave us the same things you get in all these cases.

We just worked there. We were small fish in a big pond. We were following company practice, and the jury said, yes, let them go. So it is not as simple as just convicting individuals.

It takes judgment calls as the chairman pointed out as he knows from being a prosecutor, and to this day and forever I will endorse the judgment that was originally executed.

Mr. **Hughes**. The gentleman's time has expired.

The Chair recognizes the gentleman from California.

Mr. **Lungren**. Thank you, Mr. Chairman.

Because we seem to be getting into the question of judgment calls, I would just like to establish for the record what the background of the individuals involved who made the judgment calls are.

Mr. Trott, you are a "political appointee." It seems strange we all are politicans sitting up here, and we seem to recoil from the idea that political appointees make any judgments.

I would just like you to briefly give your background with respect to prosecuting cases, your background in California; what you are doing here.

I know we have taken a long time on it, but as succinctly as possible, so we have some judgment on the record.

Mr. **Trott**. Mr. Lungren, when I graduated from law school I went directly into the district attorney's office in Los Angeles County without passing go. I did not want to be in private practice.

I wanted to be a prosecutor. I think Al Murray described my state of mind better than I could. I saw it as an opportunity to represent the decent people of the country against the bums and the crooks.

I was there for 17 years, in all capacities. I started at the lowest level and grade one, went through grade five, became the chief deputy district attorney of Los Angeles County in charge of the prosecution activities of 600 lawyers.

From there I became the U.S. attorney of the central district of California, and 2½ years ago came back here as the Assistant Attorney General of the Criminal Division.

I regard myself as a career prosecutor.

Mr. **Lungren**. You prosecute felony cases?

Mr. **Trott**. Yes; I have prosecuted every kind of felony case, including white-collar cases, that you can think of.

Mr. **Lungren**. Did you ever take a plea before?

Mr. **Trott**. Many, many times.

Mr. **Lungren**. Were pleas sometimes made based on what was referred to—Mr. Chairman, I cannot hear very well down here.

Mr. **Hughes**. The gentleman is entitled to pursue the line of questioning so everybody can here.

The Chair is having a hard time hearing.

Mr. **Lungren**. In coming up with pleas did you ever have to deal with what was referred to a moment ago as "deal breakers"?

Mr. **Trott**. Absolutely. In almost every case there is a deal breaker. You always have to confront those, and then you have to make a call as to whether or not it is a good or a bad deal. The hallmark is the deal always must benefit our side of the equation.

Mr. **Lungren**. Mr. Ogren, would you briefly state for the record what your experience has been in criminal justice?

Mr. OGREN. Sir, I graduated from law school in 1962, and after a period in private practice in New York came here to Washington in 1967, to the fraud section where I am right now. After several years as a trial attorney with the fraud section I went over to the District of Columbia U.S. Attorney's Office, and was there almost 10 years and became Chief of the Fraud Division of that office during the course of my stay there, and went for a period of several years to private practice, returned in 19—I believe it was 1980, to become First Assistant U.S. Attorney in the District of Columbia U.S. Attorney's Office, and then left there in 1982, I believe it was.

I am having a hard time remembering the exact date, March 1982, to my present position as Chief of the Fraud Section in the Department of Justice.

Mr. LUNGREN. You prosecuted felony cases?

Mr. OGREN. Yes, sir.

Mr. LUNGREN. Have you taken cases before grand juries?

Mr. OGREN. Yes, sir.

Mr. LUNGREN. Have you made decisions on pleas before?

Mr. OGREN. Yes.

Mr. LUNGREN. Have you accepted pleas before.

Mr. OGREN. Yes.

Mr. LUNGREN. Mr. Clark, could you give us your background.

Mr. CLARK. Yes.

After a few years in private practice with a private law firm in New York, I came to the Securities and Exchange Commission, the Enforcement Division in 1971. I worked under Irving Pollock and Stanley Sporkin, whom I am sure you have heard of.

In 1977 Mr. Sporkin assigned me——

Mr. LUNGREN. Was that a political position you had at that time?

Mr. CLARK [continuing]. No, sir. I was a trial attorney and then a special counsel in the division of enforcement.

In 1977, I was detailed to the Fraud Section of the Criminal Division of the Department of Justice as an SEC employee but for the purpose of working on overseas payment cases, both present FCPA cases and then after 1977 post FCPA cases, after approximately a year or two on detail to the Fraud Section, I requested a transfer to the Department of Justice.

It was accepted, and since 1979 I have been a trial attorney in the Department's Criminal Division.

Mr. LUNGREN. You have tried cases I take it, prosecuted cases?

Mr. CLARK. Mr. Lungren, many people think I have had an extraordinary series of cases at the Department of Justice. I have an unbroken record of pleas.

No one in any of my cases has ever elected at the Department of Justice to go to trial.

My wife thinks I do too good a job.

Mr. LUNGREN. We heard last week about Mr. Murray's background as a prosecutor. I would like to ask a simple question of the panel, and that is in terms of the plea that was worked out here, was it a plea based on your collective—I will ask you individually. The plea to which you agreed, I assume, as part of the consensus, was it based on your best decision as a prosecutor; based on your experience as a prosecutor, based on, as you would call it, your view of yourself as a career prosecutor?

Mr. **Ogren**. The answer is absolutely yes. I think it was an extraordinary case. I think we did the right thing. I think it was a very creative solution to an enormous problem, and it is one I am very proud of. I only wish that the complexities of this case didn't stand in the way of the full understanding of the benefit we have brought to the cash management world as a result of this case. I think it was a great result.

Mr. **Trott**. I echo everything Bob said. And I might add, one of the things that convinced me was sitting down with Bob and scoping out what it would have looked like and what it would have accomplished to go the other route. And when I weighed that—Al Murray described to you a 2-year process in Pennsylvania, with very questionable outlook, my judgment as a career prosecutor was absolutely these men were right.

Mr. **Clark**. Mr. Lungren, this was Al Murray's case. Al Murray made the decisions and the recommendations. If Al had not wanted the kind of disposition in which he achieved everything he wanted in the cash management area, none of the rest of this would have attempted to do otherwise.

Mr. **Lungren**. Can you give me an idea, Mr. Ogren, how many cases you have handled?

Mr. **Ogren**. Fraud cases, it is in the hundreds. I couldn't even begin to give you a number, but I would be surprised if anybody present in the system has handled more than I have. It is easily in the hundreds.

Mr. **Lungren**. Mr. Trott.

Mr. **Trott**. Again, I couldn't begin to guess. In 20 years, I have handled thousands of criminal cases.

Mr. **Lungren**. Mr. Clark.

Mr. **Clark**. Aside from cases in private practice, probably in my career at the SEC, maybe 12 or 18 fairly complex cases in the Securities and Exchange Commission, probably 15 to 16 complex cases in the Department.

Mr. **Lungren**. Those may seem like simple things for us to state for the record, but when we get into judgment calls, it seems to me one of the things you have to do to try and make a rational judgment about the propriety of calls is to look at the backgrounds of the people involved, see what their track records are, see whether they have any basis upon which to make these judgments. And I, quite frankly, haven't seen that, at least in the public exposure that has appeared in the print media about this case.

A moment ago, Mr. Trott, you mentioned you believed you had enough evidence to indict two middle-level Hutton officials. Let me ask you a couple things. One, if convicted, what type of sentences would these individuals have received?

Let me tell you why I ask that. I wonder if any part of your judgment was made by virtue of the fact of your consideration of whether the judiciary treats white-collar offenders strictly enough. Do you think we have too light sentences that actually are what occurs no matter what you present to the courts? And if you do think that is true, would that have an effect on your judgment in making decisions as to whether you would prosecute individuals or not in a case of this sort?

Mr. **Trott**. Let me answer your last question first. I think in the last 4 years, the judiciary—I am speaking generally about the Federal judiciary—has stepped up its sentencing with respect to white-collar criminals. In my opening statement, I talked about 2-year sentences, 4-year sentences, 5-year sentences—everybody seems to be getting the message. We have good results in the kinds of cases we are bringing because we are bringing important priority cases.

In this particular case, it was the collective judgment of the trial lawyers, had we been able to convict these particular individuals because of who they were and where they were in the scheme and the general outline of the entire case, that at most the number of years they would have gotten would have been relatively minimal, and there was a possibility of probation.

With that on the line, we thought it made no sense to pursue that as an objective in view of the other things we had accomplished right now in one fell swoop.

Mr. **Lungren**. You have mentioned before this was a case of first impression. I assume what you are talking about is the substance of the case and your ability to prosecute the case.

In terms of the agreement, the use of the injunctive relief was a case of first impression; it had never been used before, is that correct?

Mr. **Trott**. That is correct. We took this tool given by Congress and put it to good use. The use of the injunction is exactly what we told you we wanted to do with it when we got it in the first place, and I think it serves the public well to be able to lay out in a single document what you can and cannot do in a very complex area.

Cash-Flow, for example, the magazine to which I referred earlier, and all the documents circulated among money managers, have discussed this in great length. I would be amazed to find anybody in this country involved in cash management who doesn't know after the E.F. Hutton case what kind of things were allowed.

Mr. **Lungren**. Isn't it true in the case of the injunction, you were able to go beyond the substance of activities you could have prosecuted in this case and gotten conviction upon?

Mr. **Trott**. Mr. Ogren can answer that better than I could. We included things that could not be prosecuted.

Mr. **Ogren**. That is right. We were able to include the drawdown sheet scheme. We could include the retarding of the collection of checks. We were able to include the daylight overdrafting aspects of it.

Mr. **Lungren**. Thank you.

Mr. **Hughes**. The gentleman's time has expired. Perhaps at a later time in another round we can get into the question of whether the drawdown sheets, themselves, represented a violation of the law. Mr. Murray believes so. The Chair recognizes the gentleman from Kentucky.

Mr. **Mazzoli**. Thank you, gentlemen.

Let me pursue the point my friend from California, Mr. Lungren, was talking about, the judgment call, because a lot of the questions that we have had at this session we had last week with Mr. Murray, dealing with the prosecutorial discretion to plea bargain, to prosecute, to resist making contacts with lawyers, or to be more information-bearing with these contacts, and so forth.

I would like to talk a little bit about judgment calls. I tried to think this thing out, and there does appear to me no real reason why cases are bargained as against prosecuted or tried at the bar, so long as that decision was one based upon the experiences brought to the case based upon collegial decisions reached in the setting in which we operate, so as long as those decisions were not influenced by people above official pressure from above, or official pressure from the outside through political sources, contributors to campaigns, pressure from the outside from people with whom an individual in government may eventually go to work for, for remunerative jobs, pressure in effect which does distort this prosecutorial discretion, this judgmental discretion.

So let me sort of ask each of you a little bit, because we have heard about the luncheon which Mr. Fomon had with the then Attorney General, which had at least one element, a discussion of the case, and let me ask each of you, in turn, these simple questions.

Mr. Trott first. Did Mr. Smith, the Attorney General, at any time in the course of this case, call you to say, "Steve, lay off these guys, plea bargain with them. We don't want these guys to go to jail because they are going to contribute to the President's campaign, they have contributed to the President's campaign, they are good friends of mine, I am going to open a law firm again or rejoin my old firm, and I want to have them as good solid customers," or, since that obviously never took place, nobody is going to put it that bluntly and blatantly. Was there any kind of subtle pressure, body language, inference, anything which you felt indicated that you had better take a second look at this case and review it from the standpoint of minimizing the pressure individually because of these factors?

Mr. TROTT. There was nothing of the kind, nothing at all. If anything, it was the opposite. Mr. Smith—it was communicated to me through first Mr. Lazar. Mr. Smith was irked. Mr. Fomon unexpectedly used a social event to bring up a case.

Mr. MAZZOLI. So you did not hear about this directly from the Attorney General. He never did call you?

Mr. TROTT. No, I did not. I was called by the counselor to the Attorney General to simply let me know it had happened. And later we communicated back to them to tell—I think I talked to a man named Mr. Moorhead—that if you want to talk about a case, the appropriate way is through the regular channels, which is through the lawyers, to the lawyers.

Mr. MAZZOLI. Did you clear this decision you reached, Mr. Trott—Mr. Clark, Mr. Ogren, and yourself reached—about accepting the plea bargain, the injunctive relief and the rest? Did you clear that with the Attorney General?

Mr. TROTT. No. I think Mr. Smith was gone by the time that we did this. But, no, I simply advised upstairs what we were doing.

Mr. MAZZOLI. Is that typically how you do your business, upstairs? Does it have an initial when it comes back downstairs? What informed you it was time to put this bargain which you had achieved into the reality?

Mr. TROTT. That was a decision we made at our level. Upstairs had nothing to do with anything.

Mr. **Mazzoli**. You didn't send it up for concurrence, for endorsement, review of any sort? You just—it stayed with you and went from you down, but not from you up; is that correct?

Mr. **Trott**. That is correct.

I had been advising Mr. Jensen all along as to what we were doing, and he was receiving the information, saying thank you very much, and that was it.

Mr. **Mazzoli**. So you had no pressure from Mr. Smith, from Mr. Jensen, from the President.

Did you have any contact with the White House with respect to this case?

Mr. **Trott**. No. There was no pressure.

Mr. **Mazzoli**. Pressure—of course, let me just, without trying to define all kinds of pressure—let me assure you what I mean is any kind of thing, from cocktail chatter to letters which come out and threaten you.

Anything in between those areas, anything like that from the White House?

Mr. **Trott**. Nothing.

Mr. **Mazzoli**. And nothing from your superiors in the Justice Department?

Let me just expand it one more step. Any of the other agencies or branches of Government? And I realize their legion, but in that category, any pressure, any contact, any influence did you feel brought to bear upon you with respect to the decision of whether or not to go against the individuals? That is all I am concerned about.

Mr. **Trott**. None at all.

Mr. **Mazzoli**. Let me shift to Mr. Ogren.

You have heard of what I have asked of Mr. Trott. Let me ask you the whole sorts of things, and give me your narrative response with respect to: Did you hear from Trott? Did he call you at some point? Did you get leaned on by anybody above him, below him, lateral to him? Did you feel any pressure from the outside, from law firms, political contributors, anybody that might have caused you—and you have termed yourself a career prosecutor—to change your view of this case?

Mr. **Ogren**. Mr. Mazzoli, there was no pressure of any type visible to me. Steve—it was always a go-get-them approach.

As far as the issue of the lunch is concerned, Mr. Trott told me by telephone—I am not sure exactly when; it could have been the 16th or the 19th of November, as I have gone back and tried to reconstruct things—and I was angry when I heard about it. I was angry enough that I wanted to call the defense counsel for Hutton that I had been dealing with and tell him that the back dooring does not go, that will not happen, and cut it out, get control over your client.

Now, I was angry. I communicated that to Hutton's lawyers, and they apologized. And, frankly, you know, that is the kind of thing those of us who are career people are always concerned about—that that sort of thing goes on.

The only way I know how to deal with that is to kick the tails of the lawyers whose clients it is that are engaged in that kind of thing and tell them you can't do that, not with me, mister; get out of here. And they got that message, and that was the end of it.

Mr. MAZZOLI. Mr. Clark, the same essential questions.

Mr. CLARK. Mr. Mazzoli, I received no pressure, no suggestions, subtle, direct, or otherwise. And I never have in any case at the Department or the SEC.

Mr. MAZZOLI. I am proud to hear you say that, and I am proud to hear all of you say that, because Government works through people like you.

Let me shift one last question, Mr. Chairman, to Mr. Trott, because he brought up what was said by yourself today and what I think Mr. Murray said last week, and that is you view the job as a prosecutor as one representing the little people, one representing the sometimes classless people, to try to represent the good guys, try to represent truth, propriety, and correctness.

One little part of me that wiggles around just a little bit as I look at this whole case is the fact that in an effort to—and I use this analogy of Main Street and Wall Street—one solid home run could have been hit, I think, with the guy who watches the stuff on C-Span and doesn't understand all of the intricacies of this Rube Goldberg kind of thing, but simply says if you are big enough, strong enough, wealthy enough, and have big shot enough lawyers who can have dinners at Four Seasons with the Attorney General, you don't have to worry about going to the slammer.

Would there have not been, in your discretion, some element of saying, look, routinely we wouldn't do it, routinely the hell with it, it is long and lengthy, complicated prosecutions, and we wouldn't be able to use the injunctive relief? But let me tell you, the guy who watches the stuff on C-Span, the guy who lives on Main Street, he has to be assured we are not playing this hoity-toity game with handshakes in the inner sanctum and coming out smelling of Gucci and cologne, and nobody is hurt by it.

Did any part of that enter in your judgment?

Mr. TROTT. That is one of the reasons why our policy includes prosecuting individuals, and that is one of the reasons I had to be convinced—and I know Bob, Peter, and Al had to be convinced—it didn't make any sense in this case.

Public perceptions are extremely important, and we do our best to make sure the public perceives we are doing the public's business in the best possible way.

I knew we were going to get broadsided by some people for not prosecuting individuals in this case, but I think it would have been a bad judgment on that case to fear that type of a consequence and to say, well, just because somebody might not understand, because we might get jumped on, we should give up this package that establishes our results.

Mr. HUGHES. The gentleman's time has expired.

Mr. CLARK. May I say something to Mr. Mazzoli?

I am not sure what you would think of me and Al Murray—if I understand your question correctly—if we held against one or two midlevel people at Hutton who had no knowledge of that luncheon between the Attorney General and Mr. Fomon.

What would you think of us if we used that—if our pique that that had happened caused us to throw the rest of the deal away and prosecute those two individuals? I don't think—you know, we are only here through this world once, and we try to call our shots the best way we see them.

I don't think it is fair to those people to hold Mr. Fomon's intemporate act against two people who didn't know anything about it.

Mr. HUGHES. The gentleman's time has expired.

The Chair recognizes the gentleman from Florida for 10 minutes.

Mr. SMITH. Thank you, Mr. Chairman.

Mr. Ogren, you just indicated that you were extremely upset, angry, about the impropriety of the lunch Mr. Fomon had with the Attorney General. Mr. Clark indicated his pique. You say that you then communicated with the attorneys for Hutton and told them to cut it out.

Do you have any memos at all? I don't see any in the file, any memos at all, dictated by you or Mr. Clark, or Mr. Trott or the Attorney General, or anyone else with reference to the meeting, the lunch meeting between Mr. Fomon and Mr. Smith.

Mr. OGREN. I did not make a memo of that.

Mr. SMITH. Mr. Trott, did you make any memos?

Mr. TROTT. I don't believe that I did.

Mr. SMITH. Mr. Clark?

Mr. CLARK. You mean a memo when I first heard that it had taken place?

Mr. SMITH. A memo about that lunch with reference to anything directed to anyone or specifically for any particular purpose.

Mr. CLARK. Let me tell you, Mr. Smith, I don't—what I do during the day, I am fairly busy, and I don't write memos to paper the file, and I don't make a record of every telephone conversation.

In this case, because I was working with Bob Ogren, there were occasionally times when Bob might be out of the office or I might be leaving, and he might not be back from a——

Mr. SMITH. Mr. Clark, please, with reference to this particular—I don't have a lot of time, and I have an enormous amount of questions. Don't lead me around a circle.

Did you send a memo to anyone, make any written correspondence with reference to this——

Mr. CLARK. Bob Ogren was out of the office one afternoon, and I think this was probably months later, in February. But because the Attorney General, then Attorney General, Mr. Smith, was about to leave, or it was reported in the papers he was about to leave his office, I wanted to get on record Fomon's version of what had taken place, and I think there is in the materials that were given to you unredacted a note that I put on Bob's desk, I think, because he was out of the office or I was leaving the office, in which I indicated to him that I had spoken to Thomas Curnin, the lead counsel for Hutton outside counsel, in which I had told Curnin that I wanted him to get in writing Fomon's version of what had taken place.

Mr. SMITH [continuing]. Thank you.

So, you have a memo asking for the counsel for Mr. Fomon and——

Mr. CLARK. It is not asking. It is just telling Bob that I had spoken to Curnin on the telephone.

I don't think I have a copy of it here. If you want to give me a copy——

Mr. SMITH. I suggest the letter contains Fomon's recollection of where and when he arranged to meet with the Attorney General, what he said to the Attorney General, and vice versa.

So, you asked the counsel for the gentleman who was at the meeting to prepare this letter setting forth these——

Mr. CLARK. Sending a letter indicating what had taken place.

Mr. SMITH [continuing]. Did he ever do that?

Mr. CLARK. Yes, he did.

Mr. SMITH. No other memos were prepared simultaneously with the disclosure to any of the three of you that this luncheon had taken place?

Mr. CLARK. That is what I had told you before. The answer is no.

Mr. TROTT. I might be able to add some information to this. Shortly after I was advised by Mr. Lazar as to the luncheon and explained what had happened, that this was an unexpected event, Mr. Ogren called me and suggested that we ought to discover the substance of what it was that went on at the meeting.

Mr. Ogren suggested to me that for the purpose of memorializing this, we ought, if possible, to get a memo on the subject from the Attorney General.

I called the counselor to the Attorney General, who at that time, I think, was Ron Blunt, and I said, "Ron, would it be possible to get a memo as to what was said in the meeting?"

Sometime afterwards, and—I don't know, I was called back by Mr. Blunt and was told there was nothing to put in a memo.

Mr. Smith went to what he thought was a social luncheon. At the end of the luncheon Mr. Fomon tried to bring up a case. Mr. Smith was irked he tried to bring up the case.

I don't know whether I used this term or somebody else, but he "stiff armed" Mr. Fomon, told him it was not appropriate, and that was the end of it.

No memo was then prepared.

Mr. SMITH. And the Attorney General himself didn't prepare a memo on this matter?

Mr. TROTT. No. I was told he didn't think there was anything of substance that ought to be in a memo.

Mr. SMITH. It strikes me as odd, quite honestly, when there is a pending criminal matter of enormous proportions which, in your own words and Al Murray's words and others, is a case of first impression, and there is a meeting between the Attorney General of the United States and the major lead—one of the major lead players; that is, the chairman of the board of this company, who was going to be indicted, and he eventually pleads guilty to enormous amounts of mail and wire fraud.

The Attorney General, when approached about it afterwards, doesn't even think it is appropriate to make a memo. And none of you, having made copious memos during this case, make no memo whatsoever.

It strikes me as odd.

Mr. CLARK. We did not make copious memos of anything during this case.

Mr. TROTT. If anything, we have been accused of not making enough memos.

Mr. SMITH. I found the memos to be copious, certainly sufficiently on issues less important, I think, than the fact the Attorney General of the United States met with this gentleman for whatever reasons.

But let me ask you this. During the course of the investigation, immunity was given to a large number of individuals who worked for E.F. Hutton, correct?

Mr. TROTT. Nonprosecution agreements were signed; yes.

Mr. SMITH. No immunity was given to Jensen or Morley, correct?

Mr. TROTT. Correct.

Mr. SMITH. They were the two who were eventually going to be, if anybody were going to be, were going to be indicted.

Mr. TROTT. Rule 6(e) of the Federal Rules of Criminal Procedure specifically prohibits us from identifying for you any of the individuals that were involved.

Mr. SMITH. But they were not given immunity?

Mr. TROTT. There is a privacy right that attaches, and we can't discuss it in any context that might make it appear who was or was not a target involved in the grand jury.

I apologize for that, but——

Mr. HUGHES. I say to the witness that Justice has already furnished us with target defendants. And we have a list of those.

Mr. TROTT. The target letters, yes, but beyond that I don't think it would be——

Mr. HUGHES. Maybe my colleague can couch it in terms of target letters.

Mr. SMITH. It really isn't that important, Mr. Chairman.

In the end, eventually you decided to forego individual prosecutions for the corporate admission of guilt, the injunction, the fine and the reimbursement fund, is that correct?

Mr. OGREN. Correct.

Mr. TROTT. And the benefits of not having to go forward with a case that was very complex and held forth a 50-50 chance of success.

Mr. SMITH. Let me ask you first about this settlement which you find to be so great for the injured parties. Al Murray testified that was between $15 million and $250 million in illegally gotten interest gains—anywhere between those numbers—as a result of the practices of E.F. Hutton over the course of time they engaged in those practices.

You settled for $8 million. That was the——

Mr. TROTT. That is not correct at all, Mr. Smith. That is absolutely incorrect.

Mr. SMITH. Would you mind describing what the $8 million and the——

Mr. TROTT. That $8 million is not in the settlement.

Mr. CLARK. It was what Hutton reserved on its books, which actually doesn't mean they put $8 million in an account someplace; they just reserved it on their books.

Mr. TROTT. What we told Hutton was you shall repay every cent that we can show on behalf of this bank was taken plus interest, and there was no limit to it.

The limit was the amount we could demonstrate had been taken plus interest, and a special master was set up and the records were preserved in Pennsylvania, and assistance was held out to the bank so that everybody who was aggrieved by this could come in and get their money plus interest.

This was not limited to $8 million. The limit was the amount of money we could show that was——

Mr. CLARK. Hutton agreed to pay the expenses of the bank to look through their own records?

Mr. HUGHES. The gentleman does have some additional time left, about 5 minutes.

That is a vote on the rule on the tax reform bill, and what the Chair would propose to do would be to recess at this point for 10 minutes, and I would hope my colleagues could return immediately to the hearing room so we can, perhaps, proceed until about 12:30, 20 of 1, break for an hour at that time for lunch, and come back after that.

So, if my colleagues would come right back, we can proceed until about 20 of 1.

[Recess.]

Mr. HUGHES. The subcommittee will come to order.

We were in the middle of the time of our colleague from Florida, Mr. Smith, but he hasn't returned as yet. I hate to waste any more time. We have waited about 10 minutes now. So we will accommodate him with an additional 5 minutes, and I will pick up the questions at this point.

Let me see if I can describe what I understand to be the situation with regard to the handling of the case. There is no doubt, no dispute, either from the testimony or the records we received, that Al Murray, the U.S. attorney, the assistant U.S. attorney in the middle district of Pennsylvania, and John Holland and their staff conducted the investigation involving E.F. Hutton for about a year and a half before Justice became apprised of the investigation.

At some time in May of 1984, as I understand it, Justice was contacted and they were alerted at that time to the investigation, the ongoing investigation. Even though some description apparently of the investigation was given to the Justice Department in Washington, it wasn't until the following month, in June, that perhaps—perhaps I am ahead of myself. That took place earlier than May; it was March of 1984.

And then the following month, in April, a meeting took place at the Justice Department, at which time a draft indictment of almost 600 pages or over 600 pages was presented, and the case was reviewed in pretty—pretty thoroughly with the Department of Justice. And that was the first time that the department had become fully familiar with the ongoing investigation.

Is that accurate?

Mr. TROTT. It is almost accurate, Mr. Chairman.

I received a call from David Queen probably in the early part of 1984 telling me he had a significant investigation involving Hutton and money management practices.

Mr. HUGHES. Can you give us a date?

Mr. TROTT. No. And I have looked through all my records.

I do know on Monday, March 5, I met with Queen, Al Murray, Lowell Jensen, Bob Ogren and Jay Stevens, and Mr. Holland, in my conference room. We were given a briefing. That was the first meeting that we had. And it was just sort of a—for your information, here is what we have got going. We were not really involved in the case at that time.

Mr. **Hughes**. Even though Justice became aware of it, they did not get involved in March or April?

Mr. **Trott**. Mr. Ogren can illuminate that.

Mr. **Ogren**. We did on a limited basis. Mr. Murray was interested in getting support, so he could conduct an SEC analysis of the case. I went over to the SEC and obtained the assistance of three people from the SEC who agreed to go to Harrisburg with me, and we did, at the end of March or early April, somewhere in that time frame. And we sat down with Mr. Murray, got a briefing and more detail on the case with respect to potential SEC-type violations that might exist.

So that occurred in the late March/early April time frame.

Mr. **Hughes**. Same time frame.

Mr. **Trott**. Mr. Jensen wanted to make sure the SEC didn't get caught short. If we were to spring a case of this magnitude, he was concerned they be up to speed.

Mr. **Hughes**. With the exception of the work that was done relative to the SEC aspect of the case, up until that time Justice had very limited involvement, just having been briefed in a very cursory fashion in March and then finally in April at the meeting where there was an in-depth discussion of the ongoing investigation and what was involved in the E.F. Hutton case.

Then, I gather at that point, the various attorneys for the corporation and individuals had ongoing discussions with Al Murray, even though there were contacts from time to time with Justice between April of 1984 until about September of 1984. Basically, Justice's position all along was you will have to go to the U.S. attorney; we can deal with policymakers, as I understand from the memorandum in the file. But, insofar as dealing with the Justice Department of the U.S. attorney, you have to talk to Al Murray, who is handling the case in Scranton.

Is that——

Mr. **Trott**. That is my policy. You want to talk cases. You start off with the prosecutors and the U.S. attorney responsible for the case.

Mr. **Hughes** [continuing]. Now, there came a time in the fall of 1984 when the attorneys for E.F. Hutton and the individual defendants, target defendants, felt they were being shut out in Scranton and started complaining to Washington they couldn't deal with Al Murray; they wouldn't talk to him; wouldn't answer the correspondence; he had made up his mind he was going to indict.

At some point in, I believe, September of 1984, a decision was made to receive a submission at Justice in Washington from one of the attorneys. And, Mr. Clark, you participated in that review of that submission—am I correct?—a submission that was made——

Mr. **Clark**. I don't recall the date of the first submission.

Mr. **Hughes** [continuing]. Let me, if I might, just develop a record for that.

Mr. **Clark**. The first submission, as I recall, was submitted with respect to a report prepared by Arthur Young.

Mr. HUGHES [continuing]. It was a letter that was submitted by Norm Ostrow, attorney for Art Jensen, July 10, and a letter from you, Mr. Ogren, to Ostrow, dated August 8.

Without objection, I am going to offer them for the record and ask——

Mr. TROTT. Is that a "go to Harrisburg" letter?

Mr. HUGHES [continuing]. I am informed—I thought we had the letter. I am informed we don't have the letter.

There is a letter of July 10 from Norm Ostrow to Art Jensen, July 10. Are you familiar with the letter, Mr. Ogren?

Mr. OGREN. If it is the one—there were a number of letters from counsel, Mr. Chairman, that we received in June and July. They actually were to Mr. Trott. And they asked to come to Washington and raise their concerns about the case with the Department of Justice.

We talked about it, and the way we decided to handle it was a letter back from me. I wrote a series of letters. I think they were all dated August 8th——

Mr. HUGHES. Let me show you this letter rather than have you try to guess at what we are talking about. I show you a letter dated August 8, 1984, from yourself, Mr. Ogren, to Ostrow, referencing a letter to Stephen Trott, dated July 10, 1984, and ask if you will—is that the letter that you had directed to Norman Ostrow?

Mr. OGREN [continuing]. That is right.

Mr. HUGHES. In this letter, you pretty much confirm what I have indicated, the position of Justice at the time, on August 8, was you will have to talk to Scranton.

Mr. OGREN. That is correct.

Mr. HUGHES. It references a letter to Stephen Trott, dated July 10, 1984. We don't seem to have a copy of that. Is there some reason why that wasn't made available?

Mr. OGREN. It should be in your materials.

Mr. HUGHES. It is not in the materials.

Mr. OGREN. I don't know why.

Mr. HUGHES. I just checked my materials. I don't have it.

Mr. TROTT. You don't have it in your material, or it wasn't turned over to you?

Mr. HUGHES. It was not turned over to us.

Mr. TROTT. We will check. It should have been.

Mr. OGREN. The letter, Mr. Chairman, that came in, to which this is in response, was a letter I described, basically one to request a meeting or communications with Washington, and we deflected them back to Pennsylvania.

Mr. HUGHES. Now, the second point in Ogren's reply, which you have before you, in your reply, is that any effort by Washington would be only after matters had been fully concluded with the U.S. attorneys and limited to matters of policies and would not include evidentiary matters. You indicate that is the policy of the Department.

Mr. TROTT. Normally. That is generally the way we approach it.

Mr. HUGHES. What is meant by just policy review only? What do you mean by that?

Mr. **Trott**. Frequently I get called up and somebody will say "You have a U.S. attorney who is charging somebody with a bank robbery, and the identification is no good."

I tell them "I don't reweigh the average, there are hundreds and thousands of cases that go out there, I can't get involved in every one of these at that level." If somebody calls up and says, for example, as this case, somebody is about to use a novel theory to charge somebody with a crime and it isn't a crime, now that very well may be the type of thing I might listen to.

Or I have had calls, for example, somebody says it is not fair to prosecute the corporation, it is not fair to the stockholders when really this was one jerk——

Mr. **Hughes**. I see. What you are saying, it is not the policy of the Department to get involved in plea negotiations, that is something the U.S. attorney should handle.

Mr. **Trott**. Basically, yes. And it is always the policy you have to go through the U.S. attorney first unless the allegation is the U.S. attorney is completely off the reservation.

Mr. **Hughes**. Now, apparently pursuant to the ground rules, Washington, you laid down, Attorney Curnin wrote the U.S. attorney, Mr. Queen, on September 27 asking for a meeting. Without objection, I am going to put that in the record. Is there objection? Hearing none, so ordered.

[The letter follows:]

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WRITER'S DIRECT NUMBER
(212) 701-3609

RECEIVED
1984
CRIMINAL DIVISION

September 27, 1984

Re: Grand Jury Investigation of
E.F. Hutton & Company Inc.

7

Dear Mr. Queen:

On September 24, 1984, Mr. Murray informed me that he was terminating his and my joint efforts to resolve the current investigation of E.F. Hutton & Company Inc. ("Hutton") and certain of its employees. Although Mr. Murray's very recent discussion of some of his and the Grand Jury's concerns has enabled me in a very short period of time to demonstrate to him facts which have caused him to modify his earlier position, Mr. Murray's current demands remain unacceptable.

36-63-157

Throughout our discussions, Mr. Murray has assured me that my clients will receive a full and [illegible] of his tentative findings and prosecutive intentions. Accordingly, I am requesting a meeting with you to begin the review process as soon as possible. I anticipate being afforded a full opportunity to present to you all the reasons

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SEND TO FILES PROMPTLY AFTER ACTION. THIS ITEM AUTHORIZES JACKET AND OF FILE MATERIAL. DO NOT FILE IN OFFICE PASS.

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U.S. DEPARTMENT OF JUSTICE
CRIMINAL DIVISION
Dec. Unit 5
Fraud Section

why an indictment should not be returned in this matter. I believe that after two and one-half years of Government investigation, shrouded for the most part by grand jury secrecy, a reputable company and its targeted employees (with equally unblemished pasts) are entitled to a full and impartial review by you of the conduct and direction of this investigation.

As you are aware, throughout the past two and one-half years I sought unsuccessfully to meet with Mr. Murray and/or with you to assist in the fact-gathering process by offering stipulations and other means, and by detailing Hutton's factual and legal position in an effort to present all the evidence the Government demanded in the most efficient manner possible. For reasons I still do not understand, my requests were refused, resulting in the needless diversion of Government and Hutton resources in a drawn-out and expensive investigation.

It was not until July 6, 1984, that any representative of the United States Attorney's office for the Middle District of Pennsylvania (Mr. Murray) consented to a face-to-face meeting with counsel for Hutton. While Mr. Murray was courteous and willing to listen, he declined to identify any of Hutton's alleged conduct which he claimed was illegal. Such a posture rendered the presentation of Hutton's factual and legal position more than merely difficult. Thereafter, beginning on July 30, 1984 and extending to September 21, 1984, Mr. Murray and I met several times. During these meetings, Mr. Murray identified certain areas of conduct which he views as criminal and adverted to some of the evidence which he believes supports these claims. While these discussions were helpful in informing me of what areas we should be prepared to address, they were based on statements which Mr. Murray acknowledged to be far from complete. Moreover, and most disturbingly, Mr. Murray refused to particularize any of the evidence which he believes warrants the indictments of targets Thomas Rae (General Counsel), Thomas Lynch (Chief Financial Officer), Norman Epstein (Director of Operations) and, possibly, Robert Fomon (Chief Executive Officer and Chairman of the Board), who, I am led to believe, is a potential target. My firm, which represents each of these individuals, cannot responsibly respond to vague representations that unspecified documents and the testimony of unnamed witnesses establish these individuals' knowledge and approval of much of the wrongdoing allegedly committed, especially when our own investigation demonstrates that there is nothing which places these individuals in these circumstances.

Mr. Murray may well disagree with my view of our discussions and I do not wish to get into an exchange of correspondence on that issue. However, I do not believe there can be any dispute about the basic facts outlined above, viz., the length of the investigation, the unequivocal refusal to meet with Hutton's counsel for over two years, and the date on which particularization of any kind first commenced.

In the brief amount of time we have had to respond to Mr. Murray's concerns, we have been able to determine that many of his factual claims are simply erroneous. Our own investigation continues as expeditiously as possible. However, it is my understanding that the Grand Jury investigating this matter expires on or about the first week in November, 1984, and Mr. Murray is not willing to request an extension of that expiration date. Thus, little time remains for the full and impartial review of this investigation which Mr. Murray repeatedly assured us you would conduct. The time pressure is further exacerbated because we will have to appeal to the Department of Justice in Washington if, after reviewing the investigation, you deem appropriate an indictment of Hutton and/or any of its employees whom my firm represents.

I am prepared to begin my presentation to you next week. Unfortunately, the only day next week when I am available is Thursday, October 4. However, if this is not convenient for you, I am prepared to meet with you on Saturday, October 6 or Sunday, October 7, if that suits your convenience. I am prepared to disclose my clients' factual and legal positions in a good faith effort to convince you that an indictment in this matter is clearly inappropriate. I hope you will approach this review in the same spirit as Mr. Murray indicated you would. I do not seek premature discovery of the Government's case to prepare for trial; I am trying to obviate the necessity of a long and costly trial. Toward this end, I am prepared to respond specifically to each of the factual allegations we are aware of and to any others which you may elect to discuss. I believe such a dialogue is in the interests of the Government and in the interests of justice.

Finally, because a review of this matter by main Justice may soon have to be sought, I request that Peter B. Clark, Esq. be invited to attend our meetings. Time is short, the issues are many and complex, and the stakes for all are extremely high.

Very truly yours,

Thomas F. Curnin

Hon. David Dart Queen
United States Attorney
Middle District of Pennsylvania
Post Office Building
Washington & Linden Streets
Scranton, PA 18501

VIA FEDERAL EXPRESS

cc: Albert R. Murray, Jr., Esq.
Peter B. Clark, Esq.
Robert W. Ogren, Esq.
Thomas Fitzpatrick, Esq.
Joseph Gallagher, Esq.

Mr. HUGHES. In his letter, Curnin says, "Murray on September 24 informed me he was terminating his and my joint efforts to resolve the current investigation of Hutton and certain of its employees." Were you aware of this fact, that is he was terminating those discussions in an effort to resolve the matter preindictment?

Mr. TROTT. I am not personally conversant at all with what was going on in Pennsylvania between Mr. Murray, Mr. Queen and counsel.

Mr. HUGHES. Curnin goes on in the same letter, on page 2, and I am going to make a copy available to you, "Mr. Murray refused to particularize any of the evidence which he believes warrants the indictments of targets Thomas Rae (general counsel), Thomas Lynch (chief financial officer), Norman Epstein (director of operations) and, possibly, Robert Fomon (chief executive officer and chairman of the board), who, I am led to believe, is a potential target."

Curnin seems to be saying so far as Murray is concerned, having cut off negotiations, Rae, Lynch and Epstein are headed for indictment. I don't know how I can read that letter any other way. Would you agree?

Mr. TROTT. I don't know, that is double hearsay, I have no idea what it is referring to.

Mr. HUGHES. Referring to the letter.

Mr. TROTT. The only person you can ask about that is the person who wrote it or Mr. Murray. I have no idea what was being referred to in there. I at no time was involved in the preparation of this letter.

Mr. CLARK. Mr. Chairman, negotiations between Al Murray and Tom Curnin broke down and were reinvigorated many times during the course of Al's investigation.

Mr. HUGHES. Well, what I am saying is the letter would seem to very clearly indicate that the attorneys for E.F. Hutton and the individual defendants were complaining at this point they weren't getting the audience, Al Murray would not negotiate with them, they were getting to where, they wouldn't particularize the changes.

My question is: Do you read that any other way?

Mr. Trott. The letter speaks for itself. I don't know anything about it. This is a letter—I have been involved in a lot of hard-nosed negotiations, and I would hate to have what I was doing in a hard-nosed negotiation——

Mr. Hughes. Mr. Trott, we will be here all week. You know, I only ask the question. You indicated the letter stands for itself, and I am saying I can't read it any other way, and obviously you can't refute my reading of it that way.

On page 2, Curnin details concerns he has about timing of the review process. He says that the grand jury is about to expire, we are getting nowhere, we can't talk with Al Murray, he won't particularize the charges, and at some point a decision was made to review it with him.

Now, when was that made, and who made the decision?

Mr. Trott. You mean——

Mr. Hughes. At some point a decision was made in Washington to deviate from policy——

Mr. Trott. No.

Mr. Hughes. At least some——

Mr. Clark. Al promised Curnin on numerous occasions that Curnin would have an opportunity to present whatever he wanted to the Department of Justice. Curnin was concerned. Basically what you have to understand is this is Curnin's view of what is taking place, this is not necessarily Al Murray's views, it is not my view.

Mr. Hughes. I understand that. But at some point a decision was made to permit Curnin and others to make submissions to Washington.

Mr. Trott. Yes.

Mr. Hughes. When was that made, and who made the decision?

Mr. Clark. Al told them a long time before that.

Mr. Ogren. The sequence, Mr. Chairman, I think I can shed some light on that. The first substantive involvement I ever had with any of the lawyers in the case occurred in the middle of October, when an attorney for Hutton, Mr. Hundley, called and asked if they could make submissions to the Department of Justice, if they could have a meeting with the Department of Justice.

I recounted my letter of August 8 to him and told him there would not be any meetings in Washington at all until they met with Dave Queen and made their presentation to him in Harrisburg. I heard back from them essentially the kind of tune you see in this letter, they won't talk to us. I said "I will call Harrisburg, I will call Scranton and make sure you have a hearing with the U.S. attorney," and I spoke to Al Murray about it and suggested that that was really important, it had to be done, and to make sure that that occurred in the near future.

I called Mr. Hundley back and said "I think if you will call Al Murray, you can arrange a meeting." There were two meetings between counsel, Mr. Murray and Mr. Queen with, I believe, Mr. Clark present that occurred at the end of October in Harrisburg that were, in essence, the presentations that counsel was directed by my letter of August 8 to make.

It turned out that as a result of those meetings, the view of the U.S. attorney's office was to proceed. It wasn't clear to me at that point what they were going to proceed on or against whom, and counsel came back to me and said "We didn't get anywhere with the U.S. attorney's office, we want a meeting." I said "Read my letter of August 8. My letter of August 8 tells you what you have to do. You have to submit in writing to us submissions that would show us that there is some merit to meeting with us, and you don't have a meeting until we are convinced that a meeting is worth doing."

I spoke with Mr. Murray and Dave Queen and said, "Do you have any objection to that?" They said, no. I also said to Mr. Hundley, "Time is running on you, we are not going to sit here forever, you had better get those submissions in, and we will judge when they are in whether they make any difference in terms of whether we will or will not meet."

The first submissions came in on November 9. They stretched over a period of a month.

Mr. **Hughes**. Who did they come to?

Mr. **Ogren**. The first one came to me. Al was cut out of the line on the fist one, and we called up counsel for the other side and sent them to Murray, too.

From that point on, they came in to both of us.

Mr. **Hughes**. So, they came to you, but they were copied to Al Murray thereafter?

Mr. **Ogren**. That is right.

Mr. **Hughes**. What kind of submissions did you expect Curnin and the others to make? What did you expect?

Mr. **Ogren**. Typically, they were much more elaborate than what we normally get. Typically, they are memorandums that provide a factual, legal or policy basis as to why there should not be a prosecution.

I believe your staff has seen—they are thick. They are very—there might be five or six inches of submissions.

Mr. **Trott**. Does staff have those?

Mr. **Hughes**. I am not sure. I see general counsel nodding yes.

Mr. **Clark**. Mr. Gregory obtained them from my office the day before the Fourth of July weekend this year.

Mr. **Hughes**. At that time, when you talked to Al Murray, did you ascertain why Mr. Murray did not want to receive submissions from them or talk to them further?

Mr. **Ogren**. I didn't sense that he didn't want to. There were—as Peter Clark put it, there were periods in which relations between counsel, Mr. Murray, on our side, and counsel representing the company and certain of the other individuals on the other side, weren't good.

And I think they had just gone through one of those periods. I never sensed that he objected to that process.

As a matter of fact, I think he testified here last week, and he told me many times he had given his word to them they would have a fair hearing.

Mr. HUGHES. But you had to end up telling him that is the way it was going to be. He had to receive the submissions. You had to tell Mr. Murray that you wanted——

Mr. OGREN. There were no written submissions to his office. They could handle the matters in the U.S. attorney's office in Scranton and Harrisburg any way they wanted to.

The only thing that was important was that the U.S. attorney who had the ultimate decision authority and recommendation authority—as long as he was in that position, sit down and meet with counsel and hear them out.

We weren't going to get involved at the Department of Justice. I wasn't going to touch this situation until that process had been gone through.

Mr. Chairman, again, it comes back to backdooring. I am not going to let a U.S. Assistant Attorney General be backdoored by someone coming to Washington, and that is the reason why.

Mr. HUGHES. I understand that.

It would appear as if anyone looking at the memorandum and the exchange of letters between counsel and the Justice Department that, at that time, in September 1984, would it be fair to infer the U.S. attorney's office determined to move ahead with the indictments at that point? September 1984——

Mr. OGREN. Al was always talking he was going to move forward with indictments. I think he determined that before.

Mr. TROTT. That is always the long-range objective.

Mr. HUGHES. I got the flavor from the correspondence the assistant U.S. attorney had made the determination. He had a good case. He was moving ahead.

These fellows were playing hardball, and he was going to proceed full speed ahead and was getting no audience at that point. Mr. Murray refused to receive submissions. Am I incorrect in my assumptions?

Mr. TROTT. I think you are leading in the wrong direction.

Mr. HUGHES. Mr. Ogren.

Mr. OGREN. Mr. Murray, as far as I can recall, was always enthusiastic about his case, and I think that accurately states it.

I think there was a period in which there were some difficulties with counsel, and that was probably one of them, although I don't specifically recall it, and there was—the third point which was he had always committed to them having a fair hearing.

Mr. HUGHES. Did Mr. Murray say to you at any time during these discussions and this time frame between April when you were briefed fully on the case until late September that there was sufficient evidence to move ahead, he was moving ahead to secure indictments?

Did he tell you that?

Mr. TROTT. Oh, yes.

Mr. HUGHES. Did Mr. Murray feel strongly about moving ahead and indicting the corporation and the individuals that he had identified as target defendants?

Mr. OGREN. We never talked theories, and we never——

Mr. HUGHES. That wasn't my question, about theories.

Mr. OGREN. Wait a minute. It is very important we break it out that way—if you will let me answer my question in my own way, sir.

The point is we never got to specifics of who would be indicted for what. That really never happened in any of the discussions that Mr. Murray and I had.

What I had from him was a general enthusiasm, some description of the kinds of schemes Hutton was engaged in, but we never did an evidentiary evaluation, nor did I hear him say how he would intend to prove a case against any one person.

Yes, he had confidence, but we never had the discussion you are talking about.

Mr. HUGHES. The record would also seem to indicate from the documents we have the U.S. Attorney, Mr. Queen, felt strongly about that.

Mr. Queen felt the grand jury should not be extended, that, indeed, indictments should be returned, isn't that so, Mr. Ogren?

Mr. OGREN. Mr. Queen, first of all, to my knowledge was unfamiliar with the evidence. That is point one. Whether he was enthusiastic about returning an indictment or not, I know he did not know the evidence in the case.

The second point is——

Mr. HUGHES. That wasn't my question.

My question was Mr. Queen was the U.S. attorney. Mr. Queen would have to, I presume, sign any indictments.

Mr. TROTT. Mr. Murray might be able to illuminate this.

Mr. HUGHES. I am asking Mr. Ogren at this point. Mr. Ogren can answer the question.

My question is were you aware of the fact Mr. Queen felt strongly about not extending the grand jury but returning indictments against certain individuals, target defendants and the corporations?

Mr. OGREN. Dave Queen never said to me, "I want to return an indictment against A, B, C, D, E individual," never.

Mr. HUGHES. No, just individuals, certain individuals.

Mr. OGREN. Who?

Mr. HUGHES. Well——

Mr. OGREN. He didn't know the evidence. He never expressed that, sir.

Mr. HUGHES. Did you have a conversation with Mr. Queen about the *E.F. Hutton* case?

Mr. OGREN. I have had several.

Mr. HUGHES. During that timeframe——

Mr. OGREN. Yes.

Mr. HUGHES. What was Mr. Queen's attitude with regard to the extension of the grand jury?

Mr. OGREN. His attitude was reluctance, but he saw some wisdom in it.

Mr. HUGHES. Well, that is another vote, unfortunately, and it probably is a good time to break for lunch.

Let's break until a quarter of 2. That is a vote in progress. So, we will recess until a quarter of 2.

[Recess.]

AFTERNOON SESSION

Mr. **Hughes**. The subcommittee will come to order. The chair recognizes the gentleman from Florida for 10 minutes.

Mr. **McCollum**. Thank you, Mr. Chairman.

If I were having a constituent who was a public figure, or Mr. Hughes had a constituent who was a public figure, and there was a grand jury inquiring about potential misconduct in our congressional district somewhere on a public figure, and it had been going on for some time, and we were concerned or the figure was concerned about whether the grand jury was really doing anything or not, but there was a cloud obviously in the newspapers every day about it. And somebody who was the attorney for that figure wanted to have a meeting to discuss that with somebody up here, I gather from what you said so far, Mr. Trott, that the first step, of course, would be to talk with the U.S. attorney in the district, obviously, and hopefully that kind of discussion would have been going on all along.

Would this be the type of thing that you would have a discussion about? Is this a policy question as opposed to an evidentiary question, a concern over whether the U.S. attorney is really spinning his wheels and the damage potentially to that figure or something like that?

Mr. **Trott**. Yes, if the claim was that the U.S. attorney was investigating something that couldn't be and wasn't a crime, that would be something that we would look into. Claims of novel theories, and new approaches, and that is what Hutton claimed with respect to this case, that what they did was not a crime. In some sense it was standard practice, and we were really barking up the wrong tree.

Mr. **McCollum**. And what you and Mr. Ogren wanted to be put in writing before such a meeting ever took place up here, besides the assurance, of course, that Mr. Queen was being met with, as simply a laying out of something that could be relied upon as a beginning understanding that this is what you want to talk about, so we are not going to come here and talk about things that as a policy matter you wouldn't discuss yourselves directly. You would let that go strictly with the local U.S. attorney; is that not correct?

Mr. **Trott**. That is pretty much accurate. What we wanted to do is see exactly what they wanted to talk about, decide what we wanted to talk about, and then have a meeting if we were going to do so that wouldn't waste a lot of time.

Mr. **McCollum**. I would like to come to the point for a moment with Mr. Ogren of discussing with you the refinement of this case. It seems as though, in listening to Al Murray's testimony the other day, there was a period of time when the theory of the case was changed considerably from his testimony—it sounded like that—and that there was a lot of discussion during his hearing about a weekend close in proximity to the week when it was determined to extend the grand jury in November 1984, when there was a lot of preparation for trial against individuals and others, but that at some point thereafter I recall Al Murray saying that the preparation for this was not what he would like to have been in the first case and the theory of the case even changed.

Could you tell us—I assume you had a lot of workings with the theory of the case. Maybe I should be asking Mr. Clark this question, the two of you in particular—how the theory of the case developed and changed in the period of the fall of 1984 to the spring of this year when the settlement came about, the theory of prosecution.

Mr. OGREN. Yes, sir. You must understand that when Mr. Murray talked about what had transpired over that weekend, that long weekend when he was working on a draft indictment, that he did say that there never was an indictment produced, that is to say at that time there really wasn't one. It was in the computer, and I never saw one, so I couldn't address exactly what he had in mind as far as his theory at that point would be. I can only tell you what we talked about at that point, and how it changed.

Originally, the thought was that we might possibly be able to charge not only the chains portion of the case and the excessive overdrafting, but also the basic drawdown sheet and what Al calls the manhandling flipflop or the criss-crossing of checks, daylight overdrafting.

During January, after we had gone through the business of meeting with counsel, after Mr. Queen had left and after my responsibilities with respect to the case increased, I met with Mr. Murray, Mr. Holland, and Mr. Clark in Harrisburg, and we spent a lot of time, a long time going through the evidence. And we matched that up against what we believed the applicable law to be.

Mr. McCOLLUM. When was this that you had these meetings?

Mr. OGREN. It was mid-January.

Mr. McCOLLUM. Of this year?

Mr. OGREN. That is right, sir. And we matched up the law, the evidence, and what we thought was the ability level of us to persuade a jury with respect to the outcome of the case, and we essentially discarded the notion that we could charge the basic drawdown sheet as a criminal offense in itself, with a multiplier formula, and we also discarded the notion of the criss-crossing of checks between Manufacturers Hanover and Chemical Bank.

That left us with a chains case, and an excessive overdrafting case, and it was at that meeting that we decided that the further investigative efforts of the Postal Service ought to be to develop the fine tuning on the chains case. We knew they were very vulnerable on that, and we had heard, I had heard, from John Holland and his investigators that we really had about 20 chains that we felt we could prove, and I wanted to see, my own feeling was that that should be developed.

Al and Peter were in agreement, and they put together a team. They put them in a motel in Mechanicsburg, PA, starting immediately after that, and began to really build the chains case. We felt and I felt that if you could show chains throughout the United States, the only explanation could be that the money-mobilizing people were responsible for it.

It wasn't simply an accident that was confined to the middle district of Pennsylvania, the Genesee Bank situation. It was one that responsibility had to go to New York, and if we could develop that we had a solid winner, at least insofar as the company was concerned, and we didn't have other problems, and we had a criminal case.

Mr. McCollum. Why wasn't this in-depth exploration and discussion that developed these theories done sooner?

Mr. Ogren. Well, it was a responsibility for the middle district of Pennsylvania to handle the case. We had simply not reached the point at which that was a viable option. One of the reasons why we wanted, I wanted, to extend the grand jury, my motivation for it was to do precisely that. That process had never been engaged in, and this would have been, if that case had been indicted in November at that time, it would have been the only case I have ever seen of major proportions that had not any kind of serious supervisory review. That would have been an outrage. It would have been a disgrace. We should have all been ashamed if we had let that happen.

There is no alternative. You can't, if you are sitting here as a prosecutor with professional responsibility, to do the right thing, you can't let exploding guns go off because somebody doesn't have the time. You have got to sit down and do the analysis.

Mr. McCollum. Why did they get to that point of almost having the expiration of a grand jury after all this time without this serious supervisory review that you say every other case has had?

Mr. Ogren. I am not blaming anyone, because I think what happened is that we were on a collision course in time. I think Al wanted the review. He wanted to sit down and analyze the case. He was faced with a choice that really had three parts to it: decline the case, which was never an option, extend the grand jury, which was an option, or indict the case on a very, very thin review basis.

Actually, there was a fourth option, and that was to take the case and move it to another grand jury, which would have been a very, very cumbersome way of doing it. We decided, all of us decided that we had to extend the grand jury to perform what I regard as an essential basic prosecutive function, to review a case and see whether you have the evidence, not act precipitiously, and that is what we did.

Mr. McCollum. Al Murray has said that there was some excitement generated by the fiery fact that everybody got upset about the Fomon meeting with the Attorney General, the luncheon and the whole incident, and it may have focused more attention on this case upstairs. I don't know whether he was referring to you, Steve Trott, or who, that might have pushed you all into moving on this. Is there any truth to that sense, or was that just a deja vu down at the local level with the new attention that was coming anyway?

Mr. Ogren. I think Al is speaking for himself on that. As far as I was concerned, it didn't make any difference except insofar as the reaction I indicated before. I was angered by what had happened because I thought it was an out-of-channels communication, a backdoor. My objective still was, and it had been decided at that point, was to review the case. I thought that was essential.

Mr. McCollum. Based on the dates we have in your testimony earlier, November 15 was the date of the meeting between the Attorney General and Mr. Fomon for that lunch. You told us earlier today that November 13 was the date that the decision was made to extend the grand jury, so if I am correct—and correct me if I am wrong—you made the decision to extend the grand jury; is that correct?

Mr. OGREN. That is correct.

Mr. MCCOLLUM. What degree of impact or input or effect did the concern of the Hutton council for wanting more chance to put evidence in have on your decision to extend the grand jury? They wanted to extend it. Obviously their letters show that. You hadn't had that meeting, but they had had a lot of discussions down below. Was that a factor?

Mr. OGREN. Well, I can't say it wasn't a consideration, for one reason; that is, that we all were benefiting. The prosecutor always benefits when you find out what the prosecution is ahead of time. That was a tremendous plus. There is no down side finding out what a defense is in a case before you decide to indict, and even when you have an opportunity for further investigation. But I will tell you that was not my principal concern. My principal concern was that we review the evidence, that we make a decision about who it was that we were going to indict—when I say we, I mean whether it be the U.S. Attorney or the Department of Justice—that that process be engaged in, that we not go running over a cliff with something that was impossible.

Mr. MCCOLLUM. Was Al Murray saying to you in this timeframe I think we really ought to be extending this grand jury?

Mr. OGREN. Yes.

Mr. MCCOLLUM. Peter Clark, can you tell us what your input at this point was? Did you get involved in this discussion about extending the grand jury?

Mr. CLARK. Yes, sir, I was involved. I had discussions with Al Murray probably over a 2- to 3-week period preceding that week, I think Tuesday of the week. Tuesday of that week was the first working day. Monday was a holiday. I think, my recollection is that the only matter that was left to be decided on the 13th was how long we were going to extend the grand jury for.

Bob Ogren wanted only a 30-day extension. I wanted 60 days, and in talking it over with Al, Al concluded quite properly—and in retrospect absolutely accurately—that we needed additional time, and it was Al's suggestion, which Bob and I concurred in, that the grand jury extension should be for a period of 6 months, but the decision process started prior to that week with respect to the basic decision of extending the grand jury's term.

Mr. HUGHES. The gentleman's time has expired. The chair recognizes the gentleman from Kentucky.

Mr. MAZZOLI. Thank you very much, Mr. Chairman.

I want to return to my theme just for a few moments that I started out earlier which is the exercise of prosecutorial discretion, the decision which is made by your people who are on the firing line of which indictments to bring, whether to bring them, start a case, drop a case; and I, for my own part, never having prosecuted a case, I am loath to interfer with that, unless there is some evidence that that discretion has been molded, controlled, influenced, distorted in some fashion by official pressure from above or, as I have said before, pressure from the outside through political contacts or pressure from some source, and you three agree, and I wasn't here for the oath taking, I am sure you are under oath, each one of you have said clearly and forthrightly, and truthfully that you felt no pressure.

I guess the one thing that I would want to talk about just a little bit, I have read briefly, just thumbed through the big material book we have, and I notice there are several letters back and forth between counsel and Mr. Murray and Mr. Ogren and even with the then U.S. Attorney, Mr. Queen, in which counsel for some of the various parties at different times wanted to sit down and talk.

They wanted to deal. They wanted to get information, and Mr. Murray was reluctant to do it, resisted it, refused. Mr. Queen was not willing, at times you were unwilling, I think, to sit down.

It leads me to ask this question. When there was an ongoing case like this, which is being handled I must say with a respect to Mr. Murray very ably, you all were in the room and you know that big series of graphs that he unfortunately never got an opportunity to describe to us, but they described the massive information which was developed, assimilated, collated, and made somehow rational through those 2½ years, when a case is being handled that way by a professional, who feels like it is going pretty well, and he says look, I don't want to talk to these people right now, what is your policy, Mr. Trott, Mr. Ogren, about hearing directly from counsel working through the backdoor, so to speak, as Mr. Fomon attempted to do?

What do you do there?

Do you call Mr. Murray and say, "Hey all, I have got a call here from so and so, and he tells me you are being a really bad man when it comes to his case."

Now, should I talk to him?

Shouldn't I?

What do you do when you get some contact like that, or do you get contacts?

Mr. TROTT. I do, and generally speaking the first thing I do is call the U.S. attorney, if it is a complaint about a case. If it is a complaint that the U.S. attorney himself is unethical I may refer it to other offices of professional responsibility, but if the complaint simply is that something is going on, you are trying to make a mountain out of a mole hill, I will call the U.S. attorney and I will say, "Hey, what is up? An attorney just called me, wants to talk."

What do you think?

Then the U.S. attorney will frequently tell me no, we are not ready yet, send him to me. I will sort of get a general briefing what it is and I will call the lawyer back and say you have got to talk to the U.S. attorney.

On other occasions the U.S. attorney says, "Yes, we are ready to come down to Washington, let's have a meeting."

Mr. MAZZOLI. Do you routinely call the attorney?

Mr. TROTT. I call the attorney. That is the routine.

Mr. MAZZOLI. Let me kind of speculate maybe that is a kind of pressure from above, the fact that you act on each and every instance of where that is an extracurricular effort by some lawyer to beat the game by going around the backdoor, acting on those each and every time by even reporting to the U.S. attorney could be a kind of unintended unwitting sort of pressure being brought to bear on that person saying, "OK, even though I don't want to talk to this dildo, this crazy, I may have to because the guy upstairs says you know that something might be going wrong."

Is that part of your judgment, or do you think that that could be interpreted as pressure?

Mr. **Trott**. I don't believe so, because of the way we handle it, and I could give you a list of 15 or 20 U.S. attorneys I have talked to, and I am sure that to a person they would say that they never even for a second regarded it that way.

Mr. **Mazzoli**. Mr. Ogren, do you ever get contacts specifically as head of the Fraud Division from attorneys who say, "Look, I can't—the guy wont' even return my phone calls."

Not saying that he is prosecuting a bad case, not alleging fraud on his part or over reaping. He says, "Look, I want to talk to this guy and he won't even call me back." To what extent do you insert yourself into the trial tactic or the tactics that might be developing at the time by the U.S. attorney?

Mr. **Ogren**. Hopefully never into the tactics of what is going on; but I think it is important for the credibility of the Department of Justice, whether it be U.S. Attorney's Office, or Criminal Division, the Criminal Division attorneys, that we don't operate as though we don't care what the truth is.

We have to listen to what people say to us about our cases, and when there is a situation that develops in which counsel is able to make an argument that the U.S. attorney is acting in an unprofessional manner, I have to get concerned, and my concern is always—that is the number one concern that——

Mr. **Mazzoli**. Would not returning someone's phone calls be unprofessional?

Mr. **Ogren** [continuing]. It might be. It depends upon the circumstances, and I usually try in situations where that kind of issue arises to talk to the person and say look, you know what is going to happen here is very simple.

If you don't talk to these people, they are eventually going to be able to make out a case that you are an unreasonable SOB, and they will make it much, much more difficult for you to retain control over the case in your district, so please, you know, I don't want to get into your case, don't want to have anything to do with it but please think about it.

Mr. **Mazzoli**. Would it not be true, Mr. Ogren that most calls you receive, Mr. Trott, Mr. Clark, would they not come from the new dollar-a-day type lawyers who are handling probably white collar cases or fraud cases, not the murder cases, not the mainstream-type cases.

Mr. **Ogren**. In my case that is correct because that is the only kind of cases my section handles.

Mr. **Mazzoli**. Mr. Trott is moving his head.

Maybe you have been contacted on cases that are not these heavyweight-type cases?

Mr. **Trott**. Well, most Federal cases have a tendency to have a certain weight to them, but I have gotten calls on white collar cases, drug cases, public corruption cases, pornography cases.

Mr. **Mazzoli**. These are all cases that my friends on Main Street say if you know the right people you can get out, but if you don't know the right people you get slammed. Again, I guess the point I am making going back to the fact with respect to what Mr. Clark said as a rejoinder to me, I probably, had I been sitting in your chairs, have thought very clearly if I could make a case, and I wouldn't obviously want to pillory someone or crucify him where there is no evidence but if there is a case that could be made, though it would take a long projected difficult draining prosecution, I might make that case in part because it should be made correctly, and in part because of the example, if we are looking for trying to sell to the public the impartiality of the law, and second, trying to set a tempo for future conduct.

It seems to me, that occasionally those tough rigorous, demanding, prolonged kinds of cases are really involved, are really necessary.

Mr. Trott. You are correct.

Mr. Mazzoli. See this one a little bit differently than you did in that sense; but I go back to my basic premise, which is that unless somehow we find that you were leaned on, or you in turn leaned, leanor or leanee in this case, it is hard for me to look over your shoulder at this distance in time.

Can you tell me again once and maybe last, did you feel any pressure from anywhere on you to decide not to go against Fomon and some of his people?

Mr. Trott. Absolutely not, and I might add that we had been——

Mr. Mazzoli. Because understand those two middle level people that we keep setting up when you—whether against them or not is immaterial. I don't think that would have made a big difference. You have got to go against the big fish or otherwise it doesn't matter; so it is either going to have to be Fomon or those guys that sat with him in Wall Street.

Mr. Trott. Let me tell you with the risk of flirting with rule 6(e)——

Mr. Smith. Risk it.

Mr. Trott. That we have always said that it was the general agreement of everybody that we did not have sufficient evidence to prosecute the named people that you have just referred to as a group, and I think that was confirmed by Griffin Bell notwithstanding some people's view that he might since he was paid by Hutton have been compromised, but that is where we were.

We did not have the prosecution evidence on that upper echelon. Had we had that, the equation would have been viewed somewhat differently.

Mr. Hughes. The gentleman's time has expired. The Chair recognizes the gentleman from Florida, Mr. Smith, for 5 minutes to finish his first round. Then the Chair will move to the gentleman from California.

Mr. Smith. Thank you, Mr. Chairman.

Mr. Hughes. Then back to the gentleman from Florida for 10 additional minutes.

Mr. Smith. There were a number of memos issued by Mr. Holland, which we discussed last time when Mr. Murray was before the committee, and one of those memos was with reference to a meeting which all of you attended, I think, Mr. Trott, you were either there part of the time or all of the time in Feburary 1985 here in Washington.

Mr. Trott. Is that the one with Hutton's lawyers?

Mr. Smith. No, no, no, it is Justice Department officials, Mr. Murray, Mr. Clark, Mr. Ogren, at which time there was a discussion.

Mr. Trott. I don't think I was at the meeting that you are talking about.

Mr. Smith. I am sorry, it was in Pennsylvania. It was in February.

Mr. Trott. I wasn't there.

Mr. Smith. I wasn't sure if you were there. Apparently you were not there.

Mr. Trott. No.

Mr. Smith. But the others were?

And there was a statement from both Mr. Ogren and Clark that was quoted in there, not as a quote but indicated that both of you felt that you had sufficient evidence to proceed with individual indictments. That was about 3 months prior to the time that the plea was taken.

Now, I understand that we have covered that ground, and again you have indicated that at some time subsequent to that, you decided that it would be in the best interests for the case and the country to be able to take the plea from Hutton, stop the practice, get the civil injunction, and the fine, and the guilty plea?

Mr. Ogren. That is correct.

Mr. Smith. And I guess some of what have been discussed here is the judgment used in making that decision, and in whether or not in the course of having that judgment made, any pressure was brought to bear from any quarter other than the recommendations of Mr. Murray.

Mr. Murray said on Friday, however, that no individuals were prosecuted even though the Government believed that senior management knew exactly what the practices were, and I think senior management is an important word there.

I wouldn't ask you if you were developing to indict senior management when you were discussing that meeting of February 7.

I might ask you and I suppose you might invoke rule 6(e), if I ask you would you invoke that rule?

Mr. Ogren. No.

Mr. Smith. So you were discussing senior management that evening?

Mr. Ogren. I think I can explain this for you, sir. I think I know now what you are getting at.

Mr. Smith. To tell you the truth, I don't know where I am getting, so I don't know how you can answer the question.

Were you discussing senior management on February 7?

Mr. Ogren. What we were doing, the first cut at evidence evaluation which occurred in January was when we determined what theories of liability would fly as criminal theories. You know, where we could make a case at all as opposed to do where we couldn't make a case.

Mr. Smith. That is where you started to differentiate in your answer to the question of Mr. Hughes.

Mr. OGREN. Right.

Mr. SMITH. When you really didn't discuss theories of legal liability.

Mr. OGREN. Except it was clear that that applied to the company. We knew coming out of that that we had a case against the company because somebody in the company did it, even if it might be different people with respect to different acts, but you could get the company.

And what we had was a trimmed down version of the original sort of collection of theories, and we ended up with the chains and we ended up with the excessive overdrafting.

When we sat down in February and again to look at who individually might be responsible for that, it was clear as a bell, No. 1, with respect to employees who had left before the chains and the excessive overdrafting began, that they couldn't be included, and it also was clear that those who may have had knowledge of the drawdown system, which we did not believe we could charge criminally, and that is all they knew about, that we couldn't charge them as well.

So what we were dealing with when we analyzed in February was the universe of people that were Hutton employees at that time who had something to do with knowledge of, participation in the excessive overdrafting a la Williams in Alexandria or the chain.

Frankly that cuts out senior management. Senior management—we never found a shred of evidence that senior management knew about those two areas of activity.

Mr. SMITH. Let me stop you there, because my understanding is that Mr. Murray's testimony on Friday was they were not prosecuted because no one in senior management knew that the practices were illegal. Now you are telling me they didn't know about the practices.

Mr. OGREN. You are going to have to ask Mr. Murray what he meant when he said something. I can't speak for him. He is here; if you want to ask him, you can, but I will tell you that the reason why no one—the decision was made with respect to senior management regarding the case that was charged criminally is they weren't involved, and they didn't know.

Mr. SMITH. They weren't involved, and they didn't know?

Mr. OGREN. Right. I say that, you know, who knows what people know and what they are involved in? All I can tell you is what our evidence shows.

Mr. SMITH. Of course, you might know if you took them to the grand jury.

Mr. OGREN. Pardon?

Mr. SMITH. You might know if you brought them before the grand jury.

Mr. OGREN. Sir, you are assuming they weren't.

Mr. SMITH. Well, we have had a number of occasions where we have questioned E.F. Hutton people, even Mr. Fomon, and it was interesting that at the first meeting we have had with Mr. Fomon, he indicated, and Mr. Ball then subsequently confirmed, that the keyword, the watchword, the hallmark of people in this position was competition inside the corporation to generate profits, and that this practice, which was subsequently, according to them, corrupted, cash management which became overdrafting and chaining, was in fact somebody else's invention, wasn't evolved at the top level of senior management.

And I asked the question how, however, could it have been somebody else's invention, given we take as true the fact that this is a very competitive business region to region, manager to manager, when in fact the practice was almost legion throughout the whole corporation. Almost every region was doing almost exactly the same thing.

Now you have just told me that you made the decision not to prosecute individuals on the grounds that they really, senior management, did not know the practice was going on, and I hear that senior management was not aware the practice was going on, but in fact the practice is almost completely throughout the corporation about the same being carried out region by region, and I don't understand how, and I am sure you knew at the time in February, did you not, that practice across the corporation, many regions were doing the same thing.

Mr. CLARK. Which practice?

Mr. OGREN. Could I answer the question?

Mr. HUGHES. Yes, but the gentleman's time has expired.

Mr. SMITH. Mr. Clark asked which practice. I am talking about the practice of overdrafting and chaining, which was happening in more than one region of the country with Hutton.

Mr. OGREN. We came up with, in connection with—I think your impression of how widespread chaining and excessive overdrafting is is not consistent with at least my understanding of what the evidence is. Chaining—we felt we could produce evidence of somewhere around 40 chains that operated at a limited extent, yes, through all the regions but not through all the branches, nowhere near all the branches; and, a number, well, I would say a half dozen or so offices in which there was excessive overdrafting.

Mr. SMITH. You wouldn't expect nonproductive branches to be doing overdrafting in any event, so we would assume not all offices.

Mr. OGREN. You know, you are asking me to speculate. I can only tell you that my analysis was based on the evidence.

Mr. SMITH. But it was about 40, correct?

Mr. OGREN. That is what we believed we would be able to prove if we had to try the case.

Mr. SMITH. Throughout the regions?

Mr. OGREN. That is correct.

Mr. CLARK. Not every branch office in Hutton even used the plain vanilla drawdown sheet. It was not consistent throughout the Hutton organization.

Mr. SMITH. Thank you, Mr. Chairman.

Mr. HUGHES. Before I recognize the gentleman from California, in the rule 11 proceeding was an indication that there were some 50 chains identified. Would that be inaccurate?

Mr. OGREN. It could be as many as 50. It was 40 to 50. I don't have a list in front of me. I would have to go back and refresh my recollection. That is out of bounds, Mr. Chairman.

Mr. HUGHES. I see. I want to say to the gentleman from Florida, he does have 10 more minutes, but the gentleman from California will be recognized first for his 10 minutes.

Mr. LUNGREN. Thank you, Mr. Chairman.

Just for my information, I would like to ask the panel, can an assistant U.S. attorney sign the motion to extend the grand jury?

Mr. CLARK. Yes, sir.

Mr. LUNGREN. Was anyone——

Mr. CLARK. In this case, however, I believe, no. Yes.

Mr. OGREN [continuing]. I don't know.

Mr. CLARK. I think we have a copy of this.

Mr. LUNGREN. Let me just ask this. Who prepared, did you have any role in the preparation of this, Mr. Clark?

Mr. CLARK. Yes, sir.

Mr. LUNGREN. And since the date of November 15 seems to be such an important date, do you recall when you were preparing this, or when you began to prepare this extension?

Mr. CLARK. Yes, sir. It was prepared in draft prior to the week of the 13th. It was made final, the final version was prepared on the 13th, which included a period of 6 months as the period which we were asking for.

Mr. LUNGREN. As I understand it from the testimony received from Mr. Murray, he was, I assume at the same time you were, preparing the motion to extend the grand jury—preparing indictments or working up indictments.

Mr. CLARK. Yes.

Mr. LUNGREN. Is there anything inconsistent in that which would suggest that, in fact, you didn't intend to go forward to extend the grand jury?

Mr. CLARK. No, I believe Mr. Murray was trying to take out an insurance policy in the event that the district court refused. However, rule 6(g) was amended, I think, in August 1983 to permit extensions in certain kinds of cases, and this case fit.

If you look at the advisory notes for August 1983, and the extension, the modification of 6(g), this was the perfect case.

Mr. LUNGREN. As I understand it, under the rules you would only be allowed to have one motion to extend one time.

Mr. CLARK. That is my understanding—yes.

Mr. LUNGREN. If you were to err on the side of caution, that is to make sure you had enough time, I would, I assume, tend to try and extend for a longer period of time than may be absolutely necessary, because you would be prohibited from going back again, is that correct?

Mr. CLARK. That is correct. Al Murray's reasoning was that if we asked for 6 months, we could return indictment in 1 month or 3 months, but we couldn't have more time if we didn't ask for 6 months.

Mr. LUNGREN. In the hearings that we had last week, there was a document referred to from Postal Inspector Holland. For those on the panel, it is G(8), and dated February 28, 1985. He indicates in paragraph enumerated No. 2:

> As indicated in the latest preliminary report, the grand jury was scheduled to expire on November 21, 1984. During the weekend of November 11 and 12, 1984, Postal Inspectors J.C. Conroy and the undersigned Assistant U.S. Attorney Albert

R. Murray, Jr., in preparing the final draft copy of an indictment which was to be presented to the grand jury prior to its expiration, however, at the request of the Department of Justice, an indictment was not presented to the grand jury since the company and the targeted suspects had requested permission to speak directly with the Department of Justice prior to the presentation of an indictment.

As requested by the Department of Justice, an extension of the grand jury for a period of six months was obtained from the Honorable Silva Rambo, Federal Judge, Harrisburg, Pennsylvania.

That would seem to be contrary to the recitation of facts as you have given them, and I know when Mr. Holland was asked last week, he indicated that he was not a part of the Justice Department. This is recollection and so forth. I would just like to ask you specifically how you respond to the factual presentation made in this document, that Mr. Holland, although admittedly not a part of the prosecutorial team, stated it.

Mr. CLARK. Mr. Lungren, I do not know the basis for John Holland's inclusion of the reference to "at the Department's request." That was not my understanding at the time. It is not my understanding now. It was a decision, it was reached mutually between Al Murray, myself, Bob Ogren and Dave Queen.

Mr. LUNGREN. It goes on further to say, "Not only at the Department of Justice," but it says, "The indictment was not presented to the grand jury since the company and the targeted suspects had requested permission to speak directly with the Department of Justice prior to a presentation of an indictment."

Mr. CLARK. That is not inconsistent with Al Murray's testimony last Friday at all. Al had promised counsel for both the individuals and for the corporate entity that they would have an opportunity to make a presentation. Al felt very strongly that once he had given his word on that, that he was going to stick to it. And just for the record, sir, the 6(g) motion was signed both by Al Murray and myself. It is under the name of David Queen, U.S. attorney, but it was signed for him by Al and myself.

Mr. LUNGREN. Mr. Ogren.

Mr. OGREN. Mr. Lungren, I just want to pop in on one point, and that is that counsel for the company was never told by me—I don't know what Al told them—but was never told by me that we were extending the grand jury so they could make submissions. The exact opposite was told them. They were told that if they get those submissions in, we were going to go ahead and do our job on our own timetable. They had no assurances whatsoever that they were going to have a given period of time, and on several occasions, I told counsel, you know, this is taking an enormously long time. We read our incoming mail box, but this has gone beyond the period of time that I think is reasonable.

If we had been ready on November 22 and those submissions had been incomplete, as far as I am concerned, we would have gone. We wouldn't have waited. I know Al may feel differently about it, but that is what I told counsel, and that is what I was ready to do.

Mr. LUNGREN. I would like to go back to some line of questioning that Mr. McCollum engaged in with you, Mr. Ogren, concerning your, I guess I would say, position of taking over the supervisory role in this case from that of the U.S. attorney in the area. Is it in your estimation unusual for you to play this close a role in a case of this nature?

Mr. **Ogren**. No, not at all.

Mr. **Lungren**. And how do you determine, what criteria do you use for you to become this intimately involved in a case at that stage?

Mr. **Ogren**. It really depends upon the circumstances. This is one of a kind, never had anything like it really before, just from the nature of the case, and at the stage, but just this year, to give you an example of situations where our lawyer's co-counsel and I are involved, I have played similar roles in both the Butcher prosecution and the presently pending General Dynamics prosecution in California—largely the same role.

Mr. **Lungren**. The fact that Mr. Queen was leaving as U.S. attorney, would that have been an important factor to be taken into consideration when you arrived—I don't mean arrived physically, but arrived on the scene in dealing with this case?

Mr. **Ogren**. I think that was the major factor.

Mr. **Lungren**. You felt you had better knowledge of the facts, better equipped to be involved in that than a new U.S. attorney coming in?

Mr. **Ogren**. It really wasn't my call. I think that was between Steve and Dave Queen. I didn't object to it, but I think it was a major factor, as I understood it.

Mr. **Lungren**. Let me ask Mr. Trott if he would respond.

Mr. **Trott**. That was my call. Mr. Queen was leaving. There would have been no U.S. attorney on the scene during a very critical time, and a very important case of first impression. There would have been an acting U.S. attorney, at best.

It was my judgment that in the sense of good management, it would have required us to set up a careful chain of supervision on the case, and that is exactly what we did. In any event, I have general supervision over all criminal matters in the Department of Justice in my position as Assistant Attorney General. I have the authority to move in essentially on anything I wanted to for any reason along the way, but this was a situation where a vacuum existed that I felt had to be filled.

Mr. **Lungren**. Did you feel it was important at this stage of the game for you to attempt to establish policies because it was a case of first impression, or was it your reasoning to allow someone like Mr. Ogren to be involved, and then to have them present that to you at a later date, their evaluation of the case?

Mr. **Trott**. Well, eventually I was pretty sure that we were going to have a meeting in Washington to talk about this with Hutton and that policy would be developed, but my only purpose was to make sure, since as you can see we rely so heavily on U.S. attorneys, we tell the defense to get a hold of the U.S. attorney, and Al was a little bit on his own, and we just wanted to make sure that an appropriate structure of supervision and control was there on a case of that import.

Mr. **Lungren**. At any time did you feel there was insufficient manpower to be dealing with this case since it was a case of first impressions?

Mr. **Trott**. I was concerned about that when I first met Al, frankly, because I couldn't understand the case for about the first 3 hours that I was on it. It was just too large, I think, for anybody to grasp immediately, and I was very impressed at Al's knowledge and the scope of his understanding of this, but then later on in the case, I think Mr. Queen actually called up and talked to Mr. Ogren and asked for assistance. Once we got Peter Clark into the case and Bob personally looked at it, I had every confidence in the world that it was well staffed.

Mr. LUNGREN. Thank you, Mr. Chairman.

Mr. HUGHES. Before I recognize the gentleman from Florida for 10 minues on this present round, I want to advise the panel of witnesses from E.F. Hutton that we probably won't reach you, it would be my best estimate, until about 4 to 4:30 at this point. So if you would like to return, you are welcome to leave at this time.

I also might just take the opportunity, since I have the microphone, to welcome a former Member of Congress, Harold Sawyer, the ranking Republican on this particular subcommittee for four terms, and his wife, Marcia. It is good to see them in Washington.

The gentleman from Florida is recognized for 10 minutes.

Mr. SMITH. Thank you, Mr. Chairman.

Mr. Trott, let me again go back to this, because it continues to puzzle me. You just indicated, and that is not something that I think was a legal answer to a question, but for the first couple of hours while it was being explained to you, the case's magnitude was so enormous that you really didn't understand it, and I don't blame you. We didn't either for quite a while. It is a difficult case to understand, and the magnitude of it is significant.

But let me again relate that back to this question about whether senior management knew of the practices that were being followed, the overdrafting and the chaining. It was a case of enormous magnitude. We are told by all the documents and by Hutton officials that the Arthur Andersen people never advised them correctly that anything illegal was going on. We are told that the independent audit committee, which had all this information, never found out that this was going on, although you look at the audit documents, and you see starting when the practice started a bottom line which showed cash on hand all of a sudden shrinking enormously in proportion to the negotiable instruments outstanding in every given month when they closed their monthly books. Nobody ever raised the red flag on that.

We know that the practice is—according now to Mr. Ogren were 40 to 50 branches—in all regions. How does that square with senior management, and now your assessments, your assessment, both contentions that they didn't know what was going on, when the whole thing was so enormous it would be impossible in my estimation for a company as large, as well run, as money-making as Hutton would not be able internally to have a handle—sufficiently intelligent and business based as not to know when something like that is going on? The thought that that could happen literally boggles the mind.

Mr. TROTT. And thoughts that boggle the mind do not amount to evidence that can be presented in court. That was the supposition of everybody, according to what I am told, that this must reach to the highest levels of the company. But as I was advised by the trial team, the evidence was never provided to support that suspicion. That is the way we investigate the case, hypotheses, suspicions. It is like another murder case. When you walk into a house and find a dead person, a dead child, and the husband and wife crying, the husband and wife unfortunately are suspects at the beginning because they are there, and we know how murders happen.

But when you go through a case, then the case isn't anymore—what are the suspicions, what are the hypotheses, what are the "must be's", what are the "should have beens", what is the evidence? The trial team advised me the evidence was not there that would have justified bringing a case against the individuals that you are talking about at the highest levels.

Mr. SMITH. Was Mr. Morley, in your estimation, a senior official?

Mr. TROTT. No.

Mr. SMITH. So he could have, in fact, known about this, could have, in fact, initiated it, and that still would not have led you to indicting any of the senior officials, correct, unless you could connect a direct link between Mr. Morley and the senior officials?

Mr. TROTT. Mr. Smith, I apologize for not wishing to deal in names.

Mr. SMITH. You don't have to apologize. You can invoke your 6(e) privilege. I am not insulted.

Mr. TROTT. I just don't think it is fair to get into the individuals. It is not consistent with rule 6(e) by name.

Mr. SMITH. Let's take this now to the end, because we have tried from 18 different ways, but I would like to do it from the way that I find it most illustrative, and that is the after effects of the case and of your decisions. We have already established that you decided at some point in time for the guilty plea and for the fine and for the civil injunction, et cetera, to go ahead and do what you did with reference to the companies, take that plea.

Mr. Murray indicated in his testimony, I think you agree, that the practices that were being followed by Hutton were illegal. I still think Mr. Murray indicated that he felt that they were industry practices, and that the industry practices were also illegal.

Mr. TROTT. He means the exposition of the float.

Mr. SMITH. I understand what he means. We are talking about the overdrafting and the chaining.

Mr. OGREN. No.

Mr. SMITH. No, we are not?

Mr. OGREN. No.

Mr. SMITH. Go ahead. Correct me.

Mr. OGREN. Mr. Smith, I think what we all believed and still believe was industry practice. Industry practice suggests everybody was doing it, but it was beyond Hutton, it was the use of something like a multiplier or formula in the drawdown sheet, or the daylight overdrafting. That is what we believe had some degree of existence outside Hutton itself.

Mr. SMITH. Illegality.

Mr. OGREN. Well, it wasn't illegal because of the *Williams* case at the time. It is now, we believe, under the bank fraud statute, and that is why we elected—we were able to use the bank fraud statute which was enacted——

Mr. SMITH. You mean the 1983 statute?

Mr. OGREN [continuing]. It is 1984. The 1984 statute was enacted at the same time as the injunction. We felt we could reach that most equitably and most effectively by a combination of the injunction and the bank fraud statute. We do not believe to this day that those practices were in violation of the mail fraud statute.

Mr. **Smith**. Would it have been a proper defense to charge mail or wire fraud when you indicted, if this was industry practice?

Mr. **Trott**. Let me try, not as such, but to the extent it impacts on the criminal *mens rea,* the intent to defraud, that has to be shown to sustain this charge. If somebody is doing something and they have a state of mind as pure as the driven snow, because that is the way I was brought up in this industry to do it, that deprived somebody of the intent that has to go along with the act to make it a crime. Bob.

Mr. **Ogren**. That is part of it. The other part of it is that with the *Williams* case in place, to the extent you rely on an overdraft check as a representation of an amount on deposit, you couldn't do it. And that really was our theory. If you followed the discussion that Al Murray had last time with you and what I tried to say, the theory we ended up with we believed we could prosecute was an abuse of the customer relationship by lying to the banks about using the accounts only for customer money. That is really using it for noncustomer money.

We felt we were in serious trouble on that theory with respect to the drawdown sheet.

Mr. **Trott**. Bob made an important point, the use of these accounts for customer versus noncustomer money.

Mr. **Smith**. Let me ask you this. According to you, then, industry practice basically was not illegal at the time that this was being perpetrated.

Mr. **Clark**. Target balancing is an industry practice.

Mr. **Smith**. Prior to the fraud statute, the bank fraud statute.

Mr. **Ogren**. Yes. The *Williams* case has not been reversed.

Mr. **Smith**. Let me ask you this, it struck me from the very beginning of this matter as odd, the *Williams* case was a third circuit case.

Mr. **Ogren**. Supreme Court.

Mr. **Trott**. U.S. Supreme Court.

Mr. **Smith**. The *Frankel* case.

Mr. **Trott**. Construing *Williams.*

Mr. **Smith**. Was a third circuit case. Would you consider the *Frankel* case to make your job profitability even more difficult?

Mr. **Trott**. Absolutely.

Mr. **Smith**. Is the *Frankel* case followed in the third circuit today?

Mr. **Ogren**. As far as I know, it is. I would expect it would be.

Mr. **Smith**. Is it followed in all the other circuits since it is only a circuit case?

Mr. **Ogren**. I don't know, sir. I don't know whether this situation has presented itself in any other case.

Mr. **Smith**. The reason I am bringing this up, the decision to seek an indictment in the third circuit, as opposed to other places where this actual crime, as you found it to be, was being perpetrated outside the third circuit, there was an investigation going on in New York of some import with chaining and overdrafting. Why would you seek—this is what I didn't understand, as a person who dealt in the criminal for many years, why you would seek an indictment in a district where you have an infirmity or disability because of an additional amount of proof that you would have to render?

Mr. Ogren. We weren't going to do that. What we came up with was a case we thought got around the *Frankel* case problems. We came up with a case where industry practices were not a defense. We came up with a case where we thought there was no legitimate explanation for the activities involved, and we thought would be before a fair and unbiased jury a winner, but we thought we could do it. There was no need to go anywhere else.

One of the things you try to do in prosecuting cases is not to go for the most complex. They don't award style points in prosecution for degree of difficulty. You have to win the case, and you have to win it as easily as you possibly can. I get zero points for coming in with the most complex, most incomprehensible case in the world.

Mr. Smith. I understand that, and I wouldn't disagree at all. I suppose it would be easier for you, might shorten the time you might have to take if you might chose another circuit. I am curious—you made that decision around February. Now you begin to tell us the timeframe, February 1985, you made the decision to now break into theories which you had been working on for the purposes of prosecution.

And why prior to that time, knowing the disability was to a higher degree a barrier to you in the third circuit, why you didn't move anywhere else?

Mr. Trott. There is no reason to believe *Frankel* wouldn't—the same case wouldn't have been decided in other circuits the same way since it was based on *Williams.*

No. 2, the grand jury work had been done in the middle district of Pennsylvania, that circuit. Representing this to another grand jury would have been almost impossible. The six million records of Al Murray were in the third middle district. In no circumstances would it have been feasible to shift venue in this case.

Mr. Clark. What would we be improving in another circuit? 1334 had been enacted in October. Why go back?

Mr. Trott. There was no precedent we had been after. We had solved the *Frankel* problem, so it wasn't like we had to recreate another theory to make new points. Congress did that for us.

Mr. Smith. I ask the last question, which I think is most appropriate. Have you ever, since the time you made this decision to do what you did to terminate this case, have you ever investigated whether industry practice has changed significantly since Al Murray said originally, again I bring this up, I think he said that, industry practice was a—I am leaving for the time being—Mr. Ogren said he didn't think senior management knew about the practice, and Mr. Murray said he didn't indict because he didn't feel it was illegal.

But have you ever done any kind of investigation to determine whether or not the civil injunction, which is what you really wanted to get, to change, stop industry practice and hopefully change it—am I correct so far? Have you ever done an investigation to find out whether, in fact, that actually happened beyond E.F. Hutton itself? Has there been any positive impact in the industry of the decision you made?

Mr. **Trott**. We believe so. Among other things, the magazines, like Cash Flow, have set out in great detail what the new rules and regulations are. This Washington Watch section, entitled "When E.F. Hutton is Caught, Treasurers Listen," and then they talk about the impact this has had. They talk about Treasury managers, and they lay out in great detail exactly what this means and in subsequent articles, there have been a great number of interviews of people who do this for a living. I think everybody is talking about it, and at one point I believe Mr. Volcker even said M-1, seems to have been affected when we threw the brakes to this, as Al said, slowed the speed limit back on.

Mr. **Smith**. Have you done an investigation, any kind of follow-up? You might want to indicate that to one of the other members as they ask that question.

Mr. **Hughes**. I am going to pick that up, if I might, just briefly. I had not intended to get into that at this point.

Let me pick up, if I might, just from there. If I hear you correctly, you put a great deal of stock in the injunction which enjoins E.F. Hutton from certain practices. Now, in the first place, that is not binding on anyone beyond E.F. Hutton, correct?

Mr. **Trott**. Absolutely. The injunction only binds the parties in interest.

Mr. **Hughes**. Second of all, the suggestion seems to be the injunction is really the one—is what sends the signal. I just don't understand. I would think that the corporate world and the individual people that carry out corporate policy would be fearful of criminal conviction.

Mr. **Trott**. And you are correct.

Mr. **Hughes**. Criminal conviction and the signal that sends. If you engage in this kind of practice, you do it at your peril because we are going to charge you with criminal violations.

Mr. **Trott**. That is what we said by specifying this as 2,000 counts of wire fraud and mail fraud, and in the injunction, we spelled it out crystal clear.

Mr. **Hughes**. Let me follow up on that, and Mr. Ogren, you can respond if you like to a series of questions dealing with this.

The injunction, as I understand it, recites E.F. Hutton shall not engage in overdrafting except where there is an agreement with the bank. Overdrafting.

Mr. **Trott**. It doesn't quite say that.

Mr. **Hughes**. What does it say?

Mr. **Trott**. We have it here. Should it be placed in the record in evidence?

Mr. **Hughes**. Yes. Without objection, we will receive it in the record.

[Information previously supplied in June 19, July 19, and August 1, hearing.]

Mr. **Hughes**. But what is, in essence——

Mr. **Trott**. Tenet 1 of the injunction requires Hutton to disclose in writing to each bank or financial institution with which the broker maintains a depository account, "all money management practices of techniques which may affect directly or indirectly the use of such an account in connection with the concentration of funds, including intercompany funds in and out of all accounts." It requires a description of the cash concentration system to the depository banks, a statement of the effect of cash concentration procedures on those banks, and it could include a notice that a cash concentration system is designed to recapture float for the purpose of keeping compensating balances at the average target level.

So this really relates to anticipatory drawdowns. What we are saying, among other things, is if you want to engage in this stuff, at the very least you have to let the bank know what is up.

Mr. HUGHES. I, in essence, said that. I also indicated as part of the decree they are forbidden from causing uncollected funds to be drawn by any means, including the use of a multiplier formula to which Hutton maintains a deposit relationship unless there are consents to the banks authorizing withdrawals. Isn't that what I said?

Mr. TROTT. It doesn't sound to me like that is what you said.

Mr. HUGHES [continuing]. In essence, what you have done with regard to the injunction is to require E.F. Hutton to go to the bank or the banks that they deal with and work out an agreement with regard to money management and float and forbid them from drawing down uncollected funds without consent, when, in fact, that is still the practice.

I would suspect most of the corporations of this country today draw on uncollected funds with the knowledge of the banks.

Mr. OGREN. If it is with the knowledge of the banks, it is not a fraud.

Mr. TROTT. No problem.

Mr. HUGHES. I am saying that I think, in essence, what you have done with E.F. Hutton, you probably have done more than, is the standard business practice in America today with regard to banks drawing on uncollected funds.

My point is that you seem to place a great deal of emphasis on the injunction, and I have read the injunction over and over again, and I fail to understand how that is the signal that is being sent. I think the signal that was sent was the conviction of the corporation. And insofar as the injunction and the sign is concerned and the restitution is concerned, the fact of the matter is very few banks have claimed restitution, many small banks probably can't figure out what went on, and I don't know—they will know what the extent of their damage is.

Many banks, for one reason or another, decided they didn't want the publicity, didn't want to get involved in it, other banks were perhaps looking at other remedies at the time.

Mr. TROTT. You are describing some of our trial problems very well, Mr. Chairman.

Mr. HUGHES. I understand.

The point I am trying to make, and I think the point the gentleman from Florida was trying to make, is that insofar as the injunction is concerned, it is binding only against E.F. Hutton, and while it may have indicated what Justice wanted E.F. Hutton to follow, it basically is the precedent that was established by the criminal conviction that sends the signal that I think we are all anxious to send to the business world, that if they engage in excessive overdrafting as to E.F. Hutton or chaining or other schemes to defraud, that they do it at their peril.

Mr. TROTT. The injunction goes way beyond what we were able to charge against Hutton, and so the conviction would have said you can't do this. But by adding the injunction, we include a lot of behavior not in the interest or integrity of the bank.

Mr. HUGHES. I have a different view.

Mr. TROTT. The package——

Mr. HUGHES. We might differ on many things, and I will respect your right to make calls, as you call them, because you have to look at all the different variables, the complexity of the case, the fact it might take 2 years in trial and appeal, the cost involved, the proof problems.

But I have a very difficult time for you for—to accept the suggestion that there were not indications suggesting intent, in the memoranda that you had access to, that we have now, we are now privy to, such as—let me give you a few examples.

The Lynch memorandum—I don't remember the date—the Lynch memorandum which said in essence that he would double the already arbitrary proposal of Morley, which was already reaping tremendous profits to the company, as an indication of what I am talking about, which indicates knowledge.

Mr. TROTT [continuing]. You are doing what I do not do with the U.S. attorney. When they say there is sufficient circumstantial evidence to prove it, I say to the U.S. attorney, "That is great. Go get them."

Mr. HUGHES. Mr. Ogren is the one who made the statement, however, that there was proof problems, difficulty in trying to establish a case against individuals. And I say that the memorandum such as the Lynch memorandum.

Mr. OGREN. You would have to show it to me before I know what you are talking about.

Mr. HUGHES [continuing]. Let's make a copy. Let's make available to Mr. Ogren the Lynch memorandum.

Mr. OGREN. You want Mr. Murray up here to address it. He investigated the case.

Mr. HUGHES. That is not necessary.

Mr. OGREN. It is necessary. He is the one who told me about the evidence.

Mr. HUGHES. I asked you the question. You are the one who made the statement that it was difficult to establish criminal culpability on the part of individuals. And the difficulty we are all having with this case is that we have a scheme that saw 2,000 counts of mail and wire fraud involving nine regions, 113 branch offices——

Mr. CLARK. They don't tell you what kind of overdrafting it is. I am sorry, Mr. Chairman.

Mr. HUGHES [continuing]. The memorandum, as I recall it—I don't have it before me, either——

Mr. TROTT. You can have it.

Mr. OGREN. You can have my copy.

Mr. HUGHES [continuing]. I will get a copy.

[A copy of the memorandum follows:]

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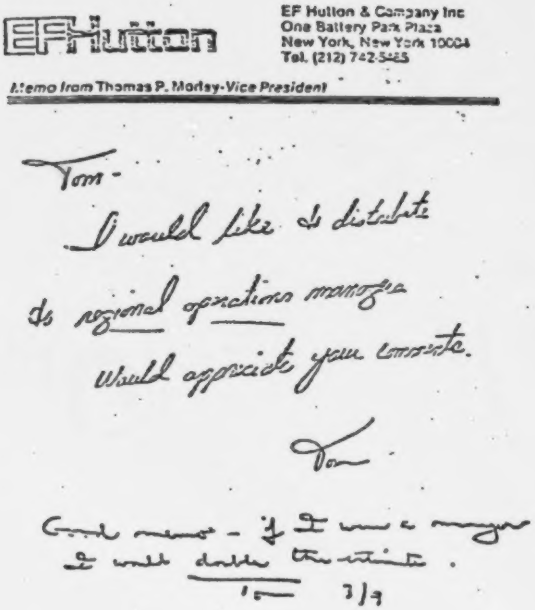

EF Hutton & Company Inc
One Battery Park Plaza
New York, New York 10004
Tel. (212) 742-5485

Memo from Thomas P. Morley-Vice President

Tom -

I would like to distribute to regional operations managers. Would appreciate your comments.

Tom

Good memo - if I were a manager I would double the interest.

Tom 3/9

NOTICE: If the film image below is less clear than this notice, it is due to the quality of the document being filmed.

EF Hutton
INTER-OFFICE MEMORANDUM

Distribution List

FROM Thomas P. Morley

DATE March 6, 1981

SUBJECT Anticipation of Late Deposits

Outlined below is a procedure pertaining to the anticipation of late deposits by the local branch. The adherence to this policy is critical to insure maximum utilization of our cash flows. It takes on added importance for the offices located in the Western part of the United States since they have to determine their daily draw down based on New York time frames. We are addressing that problem separately, but in the interim each office should follow the procedure outlined below.

Anticipation of Late Deposits –

(1) Review the amount of late deposits your branch is making. This review should cover at least a two week time frame. A late deposit is defined as being received in after you have completed your draw down.

(2) Once you have established an estimate of your daily late deposit volume, the following procedure should be implemented.

  (1) Each day, add the late deposit estimate to your daily draw down calculation.

  (2) Once you have determined the actual deposit, compare it to your estimate.

    (a) If you overestimated your deposit, draw a Chemical Reimbursement Check for the difference between your estimate and the actual late receipts, and deposit this check into your bank. Example – If your estimate of late monies is $50,000, and your actual late receipts amount to $30,000, prepare a Chemical check for the difference $20,000 ($50,000-$30,000) and deposit this check into your local bank. This will have the effect of balancing your ledger balance relative to your anticipated deposit.

    (b) If your estimate is smaller than your actual late deposit then use the excess as good funds the following day, and increase your estimate.

  (3) In no circumstance should we accept customer checks for credit the same day, if it is received too late to deposit in the bank and receive that day's credit on our bank statement. Every bank has a cut off time after which they will not accept our deposit and credit our account that day. We should strive to extend that time as late as possible but once this cut off time has been established, we should use this as our deadline for accepting customers check for same day credit.

NOTICE: If the film image below is less clear than this notice, it is due to the quality of the document being filmed.

Remember your branch gets charged for any debit balance maintained in your local bank account so it is important to estimate your late deposits on the high side.

If you have any questions regarding the above mentioned procedure, please feel free to contact me for clarification.

Tom

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Copy to:
Norman Epstein
Robert Ross

Mr. HUGHES. Doesn't it indicate he would double the already arbitrary——

Mr. OGREN. The word "arbitrary" is in here.

Mr. HUGHES. Double the amount. He would double the amount.

Mr. TROTT. Circumstantial evidence, where I come from, is not enough to get you to a jury, if it is consistent with an explanation. Most juries are told if there is a lot of circumstantial evidence floating around and one interpretation is consistent with guilt and the other is not, the jury is told you shall adopt that which is not. Circumstantial evidence is terrific, but only gets you so far. This is a judgment call as to the effect of the evidence.

Mr. HUGHES. At what period of time was it decided not to proceed against individuals, and who made that decision?

Mr. OGREN. I said that before. It was during the period of negotiations with counsel beginning May—excuse me, March 20, 21, something like that.

I would say that the decision was final some time within a month of that date, and it was Al Murray's initial recommendation, joined by Pete Clark and myself, which we brought to Steve Trott and convinced him was the right thing to do.

Mr. HUGHES. I got the impression from a memorandum that Al Murray submitted in March, which indicated that with regard to the corporate submission that regardless of whether or not the defendant, the corporate defendant, accepted the negotiations and pleaded, that a submission should be made by individuals—so that as of that date at least no decision had been made. And that was in mid to late March of 1985.

Mr. OGREN. I am sure as of that date there had been no decision made.

Mr. HUGHES. But the decision, when it was finally made, was made on the basis there was inadequate evidence to proceed against individuals.

Mr. OGREN. No.

Mr. TROTT. No.

Mr. HUGHES. OK.

Mr. TROTT. Mr. Chairman——

Mr. HUGHES. What was the basis?

Mr. TROTT [continuing]. I have repeated this 58 times since I have had this case. We gave up the opportunity to prosecute two individuals on the theories that we had an exchange for the program that we then wrote into the documents and went forward with. We had what we consider to be prosecutable cases against two people. We did not pursue them because we thought it would have been foolish to do that.

Mr. HUGHES. Let me ask you a question.

Was there a prosecutable case against Mr. Bacon?

Mr. TROTT. I am not going to get into individuals. That violates 6(e) of the spirit of confidentiality.

Mr. HUGHES. I don't know how it would violate 6(e).

Mr. OGREN. The answer was given by Mr. Murray before he was the link in the chain to go up the ladder. A classic prosecutorial technique, time-honored, as standard as you can possibly get it. You immunize people below and go up to the top.

Mr. HUGHES. Did Mr. Bacon cooperate with Justice?

Mr. **Ogren**. You would have to ask Mr. Murray. I never met with him.

Mr. **Trott**. That is an opinion.

Mr. **Hughes**. I understood you were participating in these decisions, and certainly that would be one question I would think that would arise in your discussion with Mr. Murray and with Mr. Clark, and ultimately with Mr. Trott.

Mr. **Clark**. What decision?

Mr. **Hughes**. Was there sufficient evidence to proceed against Mr. Bacon?

Mr. **Trott**. That can't be answered without getting into 6(e). This is unfair to the individuals. This is why 6(e) exists, Mr. Chairman, so that individuals who are investigated and are not prosecuted are——

Mr. **Hughes**. Was Mr. Bacon given immunity from prosecution?

Mr. **Clark**. It is our understanding Mr. Bacon has been interviewed by the majority staff.

Mr. **Hughes**. Mr. Clark, I wasn't asking majority staff. I was asking you folks. You handled the case, I thought.

Mr. **Trott**. He is free to answer things under the law, and we aren't.

Mr. **Hughes**. My question is a very simple one, and my question was: Was Mr. Bacon given immunity?

Mr. **Ogren**. I can't answer that question directly. What I can answer is indirectly, and that is that it was the effort of the investigative attorneys in this case to immunize or to obtain testimony from a level at which Mr. Bacon was in the company to make a case against higher ups.

Mr. **Hughes**. How many at his level were granted immunity?

Mr. **Ogren**. At his level, I can't give you the answer to that. I can give you an overall answer, and I can tell you that—let's see if I can find it here. I had it written down somewhere. This is from recollection and it may be a little bit off, but I believe it was 58 Hutton employees who were not subjects or targets received letters of immunity, one non-Hutton employee—of individuals who went before the grand jury. There were an additional group who received letter immunities. I believe there may have been one court ordered.

Mr. **Hughes**. It seems to me that the Bacon memorandum, when that surfaced——

Mr. **Trott**. Excuse me.

Mr. **Hughes** [continuing]. The Bacon memorandum, when that surfaced, was a critically important memorandum.

Mr. **Trott**. Yes, it was.

Mr. **Hughes**. And if you were to identify anything in any of the records I have seen as a smoking gun, that was it.

Mr. **Ogren**. That is the way we described it. It came in in March after we had extended the grand jury that we got it.

Mr. **Hughes**. Of the people that you granted immunity to, how many cooperated with the Government, of the 58?

Mr. **Ogren**. Well, you know, it depends on what you mean by that term. If you mean people who actually testified, I assume all of them did.

Mr. **Hughes**. You know what I mean. I mean to testify insofar as to their knowledge about the scheme, those within the company that participated in it, whether or not there was in fact a manual, whether or not there were training sessions. You know what I mean.

Mr. **Ogren**. Fifty-eight testified.

Mr. **Hughes**. Fifty-eight testified. How many testified cooperatively?

Mr. **Ogren**. I can't answer that, sir. You would have to ask Mr. Murray. That is a qualitative judgment. He was the one who was there.

Mr. **Hughes**. Was it the practice to determine just what evidence they would offer before immunity was granted to them?

Mr. **Ogren**. You have to ask him, sir, what he did.

Mr. **Hughes**. Mr. Murray?

Mr. Murray, why don't you come up. You have been dying to come up here today, anyway. We want you up here, in any event.

It is good to see you here today. Why don't you enlighten us as to how many of the witnesses of the 58 that were granted immunity really cooperated.

Mr. **Murray**. I can't tell you what matters happened before the grand jury. I can tell you this: When you grant someone immunity, they are compelled to testify, and they are forced to basically give testimony before the grand jury.

When you talk about cooperate, that is then a subjective determination as to the person's willingness to be forthright. I can say this: That the persons testified and they gave us evidence that was—the quality of which was of such a nature that entitled—that allowed us to define the corporation.

When you use the word "cooperate" with us, it is a subjective term. If you don't cooperate, that means you won't testify. And when you don't testify, what we then have to do, if we need your testimony, we compel it and we go through 1802(c)6001.

Mr. **Hughes**. Did you have to compel any such testimony?

Mr. **Murray**. Yes, we did, on one occasion.

I think Bob was accurate; there were 58 letter immunities granted.

Mr. **Hughes**. Was there any statutory——

Mr. **Murray**. Excuse me, 58 letters granted to Hutton employees. There was one letter of immunity granted to a non-Hutton employee. There was one statutory immunity grant; and there were 10 letters that were granted of immunity for persons who were interviewed by the Postal Inspectors, however, who did not testify before the grand jury. That was necessary in order to—just to expedite the matters.

Mr. **Hughes** [continuing]. Let me ask you this question so we can get over this. We want to get Mr. Trott home before 9 o'clock tonight.

Mr. **Murray**. I am not even sworn to testify.

Mr. **Hughes**. On any occasion, the 58 letter immunities that were granted, was there any effort to determine what testimony was offered before granting immunity?

Mr. **Murray**. Yes.

What we did, the investigative team, first, before granting immunity, we developed the evidence through the grand jury to determine exactly what we would be able to ask them about. In other words, we wanted to be—I will put it this way—loaded for bear.

So what we did, all the various chains we were trying to develop, we developed the evidence on the chains first. What we needed was to get the individuals to give some life to that testimony. Just the debits and credits going in and out of the account didn't do anything.

What we first did was prepare the evidence first. We prepared our computer-generated charts. We prepared our handwritten charts so we knew the activities in accounts. What we did was got the debit blotters, the credit blotters. We did that. Once we established that we believed a crime had been committed within that chain or there was activity, questionable activity within that chain, we would then designate specifically who was the branch office manager, who was the branch office cashier, and then call that person in based upon the evidence we had generated.

What we would then do was ask them whether or not they felt they had a right to exercise the fifth amendment against self-incrimination. If they did and we felt it was necessary therefore to compel their testimony in order to build a chain from the branches all the way up to the top, what we would do is compel their testimony.

Mr. HUGHES. I understand. I don't know if you have totally answered my question about whether or not you endeavored before they testified to find out what they would testify to.

Mr. MURRAY. Of course we did.

Mr. HUGHES. In each instance?

Mr. MURRAY. In each—in every instance we were——

Mr. HUGHES. How about——

Mr. MURRAY [continuing]. Excuse me. Excuse me.

In every instance we would approach the witness and attempt to get them to testify without a grant of immunity. When that witness, however, was represented by counsel, each and every Hutton witness invoked the—would invoke the fifth amendment privilege against self-incrimination.

And I will tell you why they did that. They did that because in the beginning of our theories—in other words, possibly the drawdown sheet might be operating as a fraud, that recapturing float might be operating as a fraud.

If, in fact, you believe that premise from the beginning, then what happens is anyone that touches on that drawdown system may, in fact, be guilty of a scheme to defraud, if you can ultimately prove it.

In the event that is the situation, each counsel then believes they can properly invoke the fifth for their client, and we couldn't then meet the argument, "Well, they are just a fact witness."

When they did that, we therefore either had to make a choice, either getting the testimony to build it to the top, to Mr. Fomon, if we could get there, or granting immunity.

Mr. HUGHES [continuing]. Let me ask you a question.

Mr. Murray, we are going to be here for the rest of the year. Let's see if we can't limit it to the question I ask.

Mr. MURRAY. I would just say——

Mr. HUGHES. My next question is with regard to Mr. Bacon. Did you ever endeavor to find out from Mr. Bacon what he would offer before you granted him immunity?

Mr. MURRAY [continuing]. We endeavored against him as we did against every single Hutton witness as to the quality and nature of the testimony that that person might provide.

I might also explain——

Mr. HUGHES. Was the Bacon memorandum serviced before or after he was granted immunity?

Mr. MURRAY [continuing]. I believe it came after. I wouldn't have prosecuted him, in any event. I wouldn't have recommended prosecution against Mr. Bacon. I was looking to try to find criminal culpability on behalf of Robert Fomon.

Mr. HUGHES. We didn't find corporate culpability at corporate headquarters. Here is what we found ourselves with——

Mr. MURRAY. One thing I was going to say—again, I want to get out of here, believe me. One thing I see that is happening is that we are calling the scheme to defraud which was later defined overdrafting practices and what is criminal and what is not.

We are mixing all those terms. It is a very specific term.

Mr. HUGHES. I don't think so, Mr. Murray.

I don't think this committee is confused about the development of the case and the evolution of the theory and the final decision at some point to go after the chaining and the excessive overdrafting.

We understand that. I am trying to question you, however, on another aspect of it at this point, and that is on the testimony before the grand jury, the grant of immunity, how it came about.

That is what I have asked you about, and you have answered my question. Thank you.

I recognize the gentleman from California for 5 minutes.

Mr. MAZZOLI. Mr. Chairman, can I ask just a brief question? I was just curious.

It seems to me, with respect to asking the kinds of question of Mr. Murray and the panel, either one of two things has to be shown; either one, they were unprofessional—Mr. Murray didn't prosecute the case correctly, didn't develop the information correctly, didn't do the things he was supposed to do correctly in his charge as representing the United States—or we have to accept that he did it correctly, though he might not have done it your way or my way or someone else's way.

But he did it because somebody leaned on him. I think we have asked questions for 2 days, and we have never—at least I am not satisfied we have been able to establish anybody used the kinds of influence that we would think would be improper.

Then the other thing is we are trying to say, professionally, Mr. Murray isn't up to snuff or these people aren't up to snuff.

Mr. HUGHES. I want to say to the gentleman that the gentleman is just off the reservation in that regard.

Mr. MAZZOLI. Is that right? The chairman can——

Mr. HUGHES. I don't see how we can make that determination unless we look at the facts. I don't see how we can make that determination unless we look at, first of all, the facts surrounding the extension of the grand jury, how it came about.

There are some discrepancies in the report. We brought them out at the last hearing. My colleague from California brought out some of the discrepancies between the Holland report and some of the testimony.

There is some documentation in here that really disputes the question as to whether the extension decision had been made on November 15.

And we haven't gotten to that yet. I don't know how you can arrive at any value judgment about whether or not there was undue pressure and what impact that luncheon had and whether or not that filtered down in some way to influence the decisionmaking unless we look at all the evidence. And that is what we are doing.

Mr. Mazzoli [continuing]. I will go along with that.

It does seem to me, you know, if we have some evidence or some belief that these people have not acted professionally, that is one thing.

Now, if we can look at—and the staff has done a remarkable job of analyzing all this information—and find somebody didn't have a clear recollection of which date one thing was done and which date something else was done, it seems to me that we may be off on the deep end ourselves.

Mr. Hughes. I say to my colleague that my colleague may, at this point, have decided for himself that—and satisfied that that is the case.

I think the rest of this committee has a responsibility, however, to look at all aspects of it to make that decision for ourselves.

I have said from the very beginning, from the very outset, we are not going to Monday morning quarterback what, in essence, was a call if it was a fair call based upon legitimate considerations and not considerations that should be extraneous to such a decision.

The Chair recognizes the gentleman from California, so we can move on.

Mr. Clark. Mr. Lungren, may I say something?

Mr. Lungren. Certainly, in answer to my next question, go ahead and say what you want to say.

Mr. Clark. In anticipation.

Mr. Lungren. In anticipation.

Mr. Clark. There is no evidence Mr. Ogren, Mr. Trott, or I are aware of that indicates in any way, shape, or form that the decision to extend the grand jury's term in this case took place any time after November 14 and probably on November 13.

Mr. Ogren. May I add something?

Mr. Hughes. Will the gentleman yield to me?

Mr. Lungren. This is not my time.

Mr. Hughes. It will be on the gentleman from Connecticut's time, just to show you how fair we are.

Why don't we put into the record a memorandum to the file, dated November 15, 1984. Without objection.

[The memorandum follows:]

Memorandum to File

Re: E. F. Hutton Group, Inc.
DJ # 36-63-157

From: Peter B. Clark

In Bob Ogren's absence, I telephoned Lawrence S. Bader earlier today in response to his letter to Bob dated November 14, 1984. We discussed the fact that over three months have elapsed since Bob's letter of August 8th, advising counsel to meet with U.S. Attorney Queen, and that other counsel have met with Queen during this period. I generally reviewed with Bader the August 8th letter, and Bader is now aware that should he seek a meeting here in Washington, he will be required to submit a written memorandum in advance of any meeting. He is also aware that any meeting would be at Bob Ogren's and/or Steve Trott's discretion.

From our discussion, I believe Bader will renew his request for a meeting in Harrisburg before he asks to come down here. For the record, Bader raised the question of whether the grand jury's term could be extended. I replied by asking whether his client desired such an extension. He immediately said "yes".

November 15, 1984

Mr. Trott. May we see a copy, please?

Mr. Hughes. Yes; we are going to provide you with it.

Mr. Lungren. Could you tell us what number is in the corner?

Mr. Hughes. It looks like GG1.

Mr. Lungren. Thank you.

I recognize there might be an explanation, but this would suggest, unless otherwise explained, that as of the 15th when you, Mr. Clark, engaged in a conversation with Mr. Lawrence Bader, that you asked Mr. Bader, because he was concerned about the grand jury, the pressure of the grand jury, he was seeking a meeting in Washington—at one point you say for the record, Mr. Bader raised the question of whether the grand jury's term could be extended.

I responded by asking whether his client desired such an extension.

Mr. Clark. That is correct. That is what I asked him. I was not about to tell Mr. Bader, Mr. Chairman, that we had plans in operation to extend the term of the grand jury.

I would never tell counsel that I had done that.

Mr. Hughes. The fact of the matter is you were going to extend the grand jury the following day, the 16th.

Why wouldn't you tell counsel at that time on the 15th that you were going to extend it on the following day?

Mr. Clark. We would never tell counsel or a witness or a prospective defendant or anybody else what we were going to do as far as scheduling the grand jury and extending its term.

Counsel has no right to know that, and we would never tell him that. This is not, Mr. Chairman, evidence in any way, shape, or form that the decision to extend the grand jury's term was made on the 15th.

I am sorry. That dog doesn't bite.

Mr. Hughes. It may be, that isn't the explanation you give. I am just saying anybody looking at this memorandum could infer, perhaps, the decision had not been made or else you would tell the counsel that——

Mr. Trott. Only somebody with a terminal case of suspicion—and I don't mean that as an insult—that is what it would take, somebody who knew nothing about law, nothing about the hardball tactics of the Justice Department, would arrive at that conclusion. Nobody else.

Mr. Hughes [continuing]. I thank the gentleman for yielding.

Mr. Lungren. I thank the Chairman.

We have a vote now. Shall we continue?

Mr. Hughes. Why don't we break right there, break and come back.

The subcommittee stands in recess for 10. [Recess.]

Mr. Hughes. The committee will come to order.

The Chair recognizes the gentleman from California.

Mr. Lungren. Thank you, Mr. Chairman.

One of the obvious points of controversy here, or a seeming point of controversy, is the question of when the decision was made with respect to extending the grand jury. The Chairman just before we left was making reference to a memorandum to the file from Peter Clark.

I think, Mr. Clark, you have explained your understanding. I suppose it depends on the way certain attorneys operate. When I practiced, I used to hold things very close to the vest, even with my best friends on the other side in cases. I could understand that while indicating to another counsel at the particular time that you wished to extend the grand jury—and not knowing whether in fact the judge was going to extend it—you could be creating a weakness in your own case or showing a weakness in your own case or revealing something to the other side, if that sort of controversy became known at a certain point in time to the other side.

I am very careful about circumstantial evidence. I guess that comes from being a member of the minority in the House. If I were in the majority, I suppose I would see how legislation gets through much more quickly. On my side, I have to see how difficult it is to build our case, and sometimes a few things in addition to building a case.

Mr. HUGHES. Would the gentleman yield to me on that and I will give the gentleman some more time?

Mr. LUNGREN. Yes, sure.

Mr. HUGHES. There are other explanations also for that memorandum, but obviously it is for the person who prepared that memorandum to submit it. For instance, if I were going to appear before the court for an extension of the grand jury the following day, and I had counsel complaining to me that he wasn't able to make a submission, and that they weren't really getting anywhere in Scranton, I might be inclined to ask counsel if he was requesting, for instance, an extension, so that I could represent to the court that I have had also requests from counsel for an extension as well as the Justice Department requesting an extension. That could be one explanation. But standing alone, it raises the following question:

It was the intent to secure the extension the following day. There had been no submissions whatsoever at that point except for one back in August. The complaint that——

Mr. CLARK. But there was no submission in August.

Mr. HUGHES. Well, there were some discussions in August. The complaint was that he had not had an opportunity to really discuss this matter with the Justice Department and/or the U.S. attorney. That was the complaint, that the time was running. The grand jury was to expire that week, and at that time it raises the question as to what is lost by saying to counsel: Well, I think you are right, and we do intend tomorrow to appear before the court and request an extension. Would you like to join with us?

Mr. CLARK. He wasn't told that at all.

Mr. HUGHES. I say it just raises those questions.

Mr. OGREN. But, Mr. Chairman——

Mr. CLARK. Not to me it doesn't.

Mr. OGREN [continuing]. I didn't speak with this counsel, but let me tell you what our strategy was because it governed what I was interested in. I mentioned it before and I will repeat it again. We weren't telling counsel to extend the grand jury because we wanted to get on with it. We wanted to get the submissions in. In fact, Mr. Chairman, there was a submission dated November 9 which was delivered to me in Washington and ultimately got to Mr. Murray.

Mr. Hughes. From Mr. Bader?

Mr. Ogren. From Mr. Huntley and from the company, but the process of submissions applied to everybody. We had started down the submission route. The one thing we didn't want is we didn't want this thing to drag out and delay, and if we tell the other side, Oh, we have extended, or we are going to extend the grand jury for 6 months, that is an invitation to them to drag out the process. That would have been a very unwise thing to do, so we did not want to tell them.

Mr. Hughes. I understand that, Mr. Ogren.

If the gentleman will yield further, the only point I make is that Mr. Bader's complaint as that he had not been able to make a submission, it would be very unlikely he could make a submission or otherwise discuss the matter overnight. You are talking about going into the grand jury the next day?

Mr. Ogren. Look, that is his problem, Mr. Bader's problem. They were all on notice that we were moving quickly. I wasn't sympathetic to their complaints. My message to them was get those submissions in.

Mr. Hughes. I thank my colleague.

Mr. Clark. This man had waited for 3 months after Bob Ogren's letter of August 8, and he hadn't done anything. He hadn't sent anything in. He sent another letter to us which was dated November 14, the day before I wrote this, and I was responding to him.

Mr. Hughes. As I understand it—and if the gentleman will yield further——

Mr. Lungren. Certainly.

Mr. Hughes [continuing]. Mr. Bader had made an effort to contact Scranton, was unable to discuss with the folks at Scranton the matter, was getting nowhere, obviously was frustrated at that point, and was complaining to you, as I gather it, just from the memorandum—maybe there are other circumstances that you can enlighten us to—complaining about his inability to either make a submission or otherwise move the plea bargaining along in Scranton. That was the complaint.

And he was saying to you, as I understand it, that the grand jury is about to expire, you know, I am concerned. I don't want my clients to be indicted before I have an opportunity to make a submission. Isn't that what he was saying? Now, if in fact there had been ongoing negotiations, discussions about a plea bargain, and counsel called me up at the last hour and the grand jury is about to expire and the pressure was on, and there had been an ongoing effort to resolve it through plea bargaining, I wouldn't tell them a thing.

Mr. Trott. This wasn't a plea bargain going on. It was still their claim that there was no crime.

Mr. Hughes. The gentleman from California, thank you.

Mr. Lungren. I thank you, Mr. Chairman.

I think one of the things that is shown now is that attorneys can differ in terms of tactics and strategy and the way they do things. I frankly look at this and I can't find any problem from it, because the way I handled my lawsuits I was close to the vest in dealing with people even such as this.

I would just like to ask if there are any documents other than the ones that we have actually had you take a look at here today, and make reference to, that would give us any further clues on when the decision was made. Let me put it this way, to substantiate the position that all three of you have taken and Mr. Murray had taken, that this was done prior to the date of the controversial luncheon.

Are there any other memos to the file or memos to either one of you that were presented to us? The reason I asked that, I know you sent us a lot of stuff. I have to tell you frankly, I haven't looked through all of this that we have, and I know there is a hundred times more material somewhere else that the committee has that I haven't had a chance to get my hands on.

Mr. CLARK. Mr. Lungren, there is only one other memo or note that I can recall exists.

Mr. LUNGREN. Can you describe it?

Mr. CLARK. It was furnished to the committee staff. I think we numbered all the documents before we turned them over. I believe it is either 4522 or 4322, and it is a note from myself to Bob Ogren. It in substantial part deals with a discussion I had with Al Murray concerning whether or not the Postal Service was going to keep the case fully staffed during any period of extension of the grand jury's term, but it is a note that I sent to Bob or left on his desk in the morning, probably the 14th of November, before Bob left on a 2-day trip to Florida, and the——

Mr. LUNGREN. Is the note dated?

Mr. CLARK [continuing]. No, it is not dated.

Mr. LUNGREN. Can you give us any idea how you determined that it would probably be on the morning of the 14th?

Mr. CLARK. Because Bob wrote on it, and gave it back to me before he left for Florida, and he left—he can tell you the time he left, but I believe it was some time in the morning around noontime, the 14th.

Mr. LUNGREN. What does that note have to do at all with——

Mr. CLARK. In pertinent part it says—this is me writing to him—"I will be in Harrisburg on Friday and will file the motion to extend the grand jury's term." It indicates to me, and I think should indicate to everyone else, that at least by the morning hours of the 14th we were in final shape.

Mr. LUNGREN [continuing]. Mr. Chairman, I would like to ask if we can have that entered into the record, if we can determine precisely which document it is.

Mr. HUGHES. Without objection, it is so ordered.

[The note referred to follows:]

Bob:

According to Al Murray, Steve Trott was asked by Dave Queen to call Ken Fletcher, the Chief Postal Inspector (245-5445) to request that the Postal Service maintain their level of commitment on the Hutton case during the period that the grand jury will be extended. Apparently the regional inspector in Philadelphia has said he wants to pull the team off until the case is indicted. I'm not sure we need to remind Steve to do something, but Murray has asked that we inquire as to whether Steve has spoken with Fletcher. Since you have had the contact with Steve on Hutton, it might be better if you asked him.

I'll be in Harrisburg on Friday, and will file the motion to extend the grand jury's term. If you speak with Steve, please let me know the result so I can tell Murray and Queen.

Peter

Mr. HUGHES. While the gentleman is taking the time, will the gentleman yield to me to introduce into the record certain documents, mostly correspondence between counsel and the Justice Department. It would be A1A through AFF. Is there objection?

Hearing none, it is so ordered.

[The information follows:]

12-7

3-8-85

Al:

The Hundley meeting may be rescheduled for the morning of the 19th or the 21st. Hundley will let us know next week (early). They are apparently having a big pow wow in NYC on the 18th in the morning. I hope to have a draft civil injunctive complaint and injunction prepared by next Tuesday. I could not remember whether we have something scheduled for Tuesday in Harrisburg. Call me on Monday night and let me know---I'll be returning from Dallas at about 7pm. I'm set for the Castellano interview in NYC on Saturday: but let's make it for early in the morning, so I can get back to DC by 2 or 3pm. Where are you going to stay in NY? The enclosed letter (and some subpoenas) might be a good idea---send 'em out if you want to. It will keep the pressure on. If you need to reach me over the weekend, I'll be at the Loews Anatole Hotel, Dallas, [214] 748-1200. Ask for Sandy.

I'm sending this to Harrisburg and Scranton. One should reach you.

Pete

P Clark 12-5

March 19, 1985

Memorandum to File: E.F. Hutton & Co., Inc.

Tom Curnin called at 5 o'clock this afternoon and advised me that he has been authorized to negotiate with us a disposition of the charges proposed to be brought against Hutton, which disposition would include a felony plea [which would not "cripple the company" in terms of its continuing to do business], a criminal fine, costs of prosecution, restitution and a civil injunction. They are proceeding with the creation of a committee of the Hutton board which will have authority to ratify any agreement we make. Curnin et. al. will be here at 2pm on Thursday, March 21st to begin negotiating. I have called Murray and advised him of Curnin's call.

Peter B. Clark

12-7
P Clark

t: 3/27/85

RWO:JPC:PBC:emm
36-63-157

MAR 27 1985

Thomas F. Curnin, Esquire
Cahill, Gordon & Reindel
80 Pine Street
New York, New York 10005

Re: E.F. Hutton and Company, Inc., et. al.

Dear Mr. Curnin:

Enclosed please find draft copies of a plea agreement, and various consents and final judgments of permanent injunction in the captioned matter. We expect to have available for you, by the close of business today, a draft civil injunctive complaint. These drafts are, of course, submitted to you for the purposes of negotiation only.

Sincerely yours,

Robert W. Ogren
Chief, Fraud Section
Criminal Division

Records
Section Chron.
Clark/2

By:
Peter B. Clark
Trial Attorney

Enclosures

cc: William G. Hundley, Esquire

RWO

BEST COPY AVAILABLE

12-10

Memorandum to File

April 1, 1985

E.F. Hutton Group, Inc.

I received a telephone call at home at 9pm yesterday evening from Tom Curnin. On Friday, I had asked Curnin to call me no later than 5pm on Sunday with the company's decision on the guilty plea to mail and wire fraud charges. The reason for the deadline was to give us enough time to warn Al Murray and John Holland so that they could avoid making the trip down here in the event the company was not going to bite the bullet on mail and wire fraud. Curnin said that he had discussed the matter with the company's outside directors and that they were agreed "hypothetically" to enter pleas to mail and wire fraud, but would not actually agree until they had examined the information. When I attempted to ascertain whether this response met our pre-meeting requirements, including whether he meant a guilty plea, nolo, etc., Curnin hung up.

12-11

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April 2, 1985

Re: In re Grand Jury Investigation
E.F. Hutton & Company Inc., et al.
Index No. 82-0196

Dear Mr. Ogren:

Enclosed for your review and consideration is our revision of the Plea Agreement we discussed yesterday. We have not yet completed our review of the Government's proposed formula which is referred to as Schedule 1 in the enclosed draft. I hope to have our suggested version available later today.

As with previous submissions, this document is being submitted in connection with plea negotiations pursuant to Fed. R. Evid. 410 and Fed. R. Crim. P. 11(e)(6). We further request that this plea agreement be treated as confidential for purposes of the Freedom of Information Act.

Very truly yours,

Thomas F. Curnin

Thomas F. Curnin

Robert W. Ogren, Esq.
Chief, Fraud Section
U.S. Department of Justice
315 9th Street, N.W.
Washington, D.C. 20006

440

[Enclosure]

BY HAND

cc: Peter B. Clark, Esq.
Albert R. Murray, Jr., Esq.
William G. Hundley, Esq.
Mr. John [illegible]

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WRITER'S DIRECT NUMBER
(212) 701-3609

April 18, 1985

Re: In re Grand Jury Investigation
E.F. Hutton & Company Inc., et al.
Index No. 82-0196

Dear Bob:

Enclosed are the drafts of the Information, Plea Agreement and Complaint which you forwarded to us on Monday, and Exhibit C which came in yesterday. I have reviewed these documents and marked on each my suggested changes.

I need to discuss these changes with you and reach final agreement by tomorrow afternoon.

I understand that other drafts came in yesterday on consents, etc. but I have not reviewed them but for Exhibit C.

Sincerely,

Tom Curnin

Thomas F. Curnin

Robert W. Ogren, Esq.
Chief, Fraud Section
U.S. Department of Justice
315 9th Street, N.W.
Washington, D.C. 20006

[Enclosures]

cc: Peter B. Clark, Esq.
Albert R. Murray, Jr., Esq.

12-1.

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WRITER'S DIRECT NUMBER

(212) 701-3609

April 19, 1985

Re: In re Grand Jury Investigation
E.F. Hutton & Company Inc., et al.
Index No. 82-0196

Dear Bob:

Enclosed are revisions to the Information, Plea Agreement and Complaint discussed today.

1. Information: I have enclosed revised pages 1, 5 and 6. All other changes in our draft of 4/18/85 are to be incorporated in the final version.

2. Plea Agreement: I have enclosed revised pages 2, 3, 9 and 10. All other changes in our draft of 4/18/85 are to be incorporated in the final version.

3. Complaint: I have enclosed revised pages 2, 7, 11 (where we have not yet resolved how to treat the question of affiliates because of the problem with what is meant by "operating affiliates" and "actual control"), 13 and 14. All other changes in our draft of 4/18/85 are to be incorporated in the final version.

Sincerely,

Thomas F. Curnin

Thomas F. Curnin

Robert W. Ogren, Esq.
Chief, Fraud Section
U.S. Department of Justice
315 9th Street, N.W.
Washington, D.C. 20006

[Enclosures]

cc: Peter B. Clark, Esq.
Albert R. Murray, Jr., Esq.

12-13

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WRITER'S DIRECT NUMBER
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April 23, 1985

Re: In re Grand Jury Investigation
E.F. Hutton & Company Inc., et al.
Index No. 82-0196

Dear Peter:

Our draft of Exhibit B is enclosed.

Sincerely,

Thomas F. Curnin /js

Thomas F. Curnin

Peter B. Clark, Esq.
U.S. Department of Justice
Federal Triangle Building
315 9th Street, N.W. - Room 826
Washington, D.C. 20530

[Enclosure]

BY HAND

12-4 RC

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WRITER'S DIRECT NUMBER

(212) 701-3609

April 25, 1985

Re: E.F. Hutton & Company Inc.

Dear Mr. Clark:

Please be advised that we have reviewed the Government's drafts dated April 24, 1985 as amended by the revised pages sent to us on April 25 and, with the exception of three minor changes, find the resulting revised draft to be acceptable in all respects. Moreover, Company management has likewise reviewed and approved these drafts, as reflected by the signatures of Messrs. Pierce and Lynch hereon.

Company management will submit these drafts to the Board of Directors of Group and Inc. for approval and management expects that such approval will be forthcoming.

Very truly yours,

Thomas F. Curnin

Thomas F. Curnin

Peter B. Clark, Esq.
  Trial Attorney
Criminal Division
United States Department
  of Justice
Federal Triangle Building
315 9th Street, N.W.
Room 826
Washington, D.C. 20530

CONSENTED TO:

THOMAS P. LYNCH
President
E.F. Hutton Group Inc.

SCOTT PIERCE
President
E.F. Hutton & Company Inc.

cc: Albert R. Murray, Jr., Esq.
    William G. Hundley, Esq.
    Thomas W. Rae, Esq.

Bob:

Attached are the Complaint and the Information. The Plea Agreeement and Exhibit "C" are redone, but waiting word that Curnin and Murray have agreed upon the language of the bank expense reimbursement clause. I placed several calls to Curnin during the day, but he returned none of them. I finally reached him at 4pm and reviewed briefly with him the major changes. He said he would call Murray immediately on the bank expense matter, but had not done so by 7pm. On the complaint we have two major unresolved problems: 1] Curnin says that his language "Hutton Group is named a defendant in order to ensure complete and effective relief against the acts complained of herein." is final, a deal-breaker and that the directors won't sign unless it's in. I doubt seriously whether the board will go to trial over the absence of this sentence, but I don't think it is as serious a problem as Curnin's second "deal-breaker". 2] is that Curnin insists that Wherefore para. "2" contain nothing about "disbursements" and must be his language. He cannot, or will not, give any other explanation than to say that "disbursements" were not "part of the deal". Again, I don't think they will go to war over this, unless we are missing something of great import in this language.

Two other matters. Curnin is now flinching at the 2,000 counts. I really think we are setting ourselves up for criticism if we tried to retroactively apply the jumped-up fine provisions. Why put ourselves in the position of having to explain an otherwise illegal sentence, and risk a post-plea motion, just to make it look better for Hutton. They agreed to the 2,000 counts and let's hold them to it.

We should also consider seriously giving Curnin another deadline. I suggest that we tell him tomorrow morning that we, the lawyers, should agree upon all the language by the close of business on Wednesday. We are very close, and there is nothing to bar working out the very minor remaining points. If Curnin balks, then I believe we should tell him that we consider them to be stalling. Curnin can present the papers to the Board on Thursday and the Board can give an up or down decision. If it's down, then Curnin should understand that we will not negotaite further. Curnin has to know that we will indict, even if you and I know that that is not the optimum set of circumstances. If Curnin thinks he can come back from the Board meeting and bargain some more, then we will really be up against the time barrier as far as indictment is concerned. Murray and I will have little more than a month to put an indictment together and prepare for motions and trial; I personally do not want Curnin bargaining while I am doing that, because we will not get any cooperation from the company in finishing the grand jury presentation. They have amply demonstrated that already, over the past month.

12-17

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WRITER'S DIRECT NUMBER
(212) 701-3609

March 12, 1985

Re: In re Grand Jury Investigation
E.F. Hutton & Company Inc., et al.
Index No. 82-0196

Dear Mr. Murray:

I am in receipt of your letter of March 5, 1985 and the attached subpoenas.

As you are aware, the Company incurred a great deal of time, effort and expense in complying with the Grand Jury subpoenas dated May 10, 1982. Indeed, due to your insistence that the Company respond to the subpoenas as drafted, with only slight modifications, compliance was tremendously complicated and resulted in the production of millions of documents at a tremendous cost to the Company. If it should develop that, through inadvertence, compliance with these subpoenas was not complete in every respect, that would not demonstrate lack of cooperation or good faith compliance with these subpoenas, especially given the tremendous burden which compliance placed on the Company. Moreover, as we have repeatedly told you, non-regulatory records of routine occurrences were not normally maintained by the Company. Indeed, certain of the records produced from time to time subsequent to the Company's response to the subpoenas came from personal files that had not previously been believed to contain responsive materials. On this record, your conclusion that the Company "is attempting to intentionally thwart the grand jury investigation" is simply not justified. As you have from time to time in the past felt free to inform me that, in your view, lawyers and witnesses have not been cooperating, I can only assume that if there was any substance to your claim, you would have long since apprised me of it. As you are aware, whenever material responsive to your subpoenas was uncovered, the Company produced it.

On a wholly different note, however, is your very serious charge about document destruction. I know of no information that would support such a charge or your contention that "[redacted]"may have been intentionally destroyed" as a result of the grand jury investigation. If you believe you have any information to the contrary, I think you are under a duty to apprise me of it so that we may review and evaluate this claim.

As for the grand jury subpoena dated [redacted] our respective positions are fully set forth in the letters exchanged between you and us dated May 8, 1984, May 17, 1984, July 25, 1984, July 27, 1984 and August 8, 1984, and our subsequent conversation in Harrisburg confirming that compliance with that subpoena was adjourned pending the outcome of your efforts to narrow the subpoena.

As you are fully aware, the Company is unable to comply with the [redacted] subpoena addressed to the Custodian of Records by March 15, 1985 and, indeed, such a request at this time is exceedingly burdensome and unnecessary and, therefore, I believe that it would be in our mutual best interests to discuss the scope of this subpoena which I can do at your convenience.

Sincerely,

Thomas F. Curnin

Albert R. Murray, Esq.
Assistant U.S. Attorney
U.S. Department of Justice
Middle District of Pennsylvania
Post Office Building - Room 426
Washington & Linden Streets
Scranton, PA 18501

VIA FEDERAL EXPRESS

cc: Robert W. Ogren, Esq.
Chief, Fraud Section
U.S. Department of Justice
Criminal Division
Washington, D.C. 20530

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WRITER'S DIRECT NUMBER
(212) 701-3609

March 19, 1985

Re: In re Grand Jury Investigation
E.F. Hutton & Company Inc., et al.
Index No. 82-0196

Dear Mr. Murray:

Further to our conversation last week, enclosed herewith please find a copy of the notice that was sent to the branch offices and regions today to collect the material identified.

Sincerely,

Tom Curnin

Thomas F. Curnin

Albert R. Murray, Esq.
Assistant U.S. Attorney
Middle District of Pennsylvania
Post Office Building - Room 426
Washington & Linden Streets
Scranton, PA 18501

[Enclosure]

VIA FEDERAL EXPRESS

cc: William G. Hundley, Esq.
J. Clayton Undercofler, III, Esq.
Thomas Fitzpatrick, Esq.

Memorandum to: All Regional Vice Presidents
All Regional Operations Managers and
All Branch Managers

From: Thomas W. Rae,
Executive Vice President
and General Counsel

[redacted]

Your branch or region previously was required to collect and forward to a regional facility similar documents. This request will require a new search of all pertinent branch and regional files.

It should be emphasised that this memo requires a search and production from any source. It is not limited to central branch files; it includes any personal or private files, and it does not matter whether the documents are kept by office personnel, in your desk, in your home or elsewhere.

If you have any doubts about whether a given document comes within the scope of this memorandum send it to New York anyway.

No later than Monday, March 25, you must forward all such documents to Bob Brunton at New York Legal by Federal Express. At the same time you are required to complete and send to Mr. Brunton the attached certificate of compliance with this request, and wire Mr. Brunton that you have complied with these requirements.

The importance of strict compliance with this request cannot be overemphasised.

CERTIFICATION

To: Legal Department

Attn: R. Brunton

I hereby certify that I have compiled and forwarded to you

[redacted]

Branch Manager,
Regional Vice President, and
Regional Operations Manager

Office - Name and Number

12-19
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WRITER'S DIRECT NUMBER
(212) 701-3609

March 28, 1985

Re: In re Grand Jury Investigation
E.F. Hutton & Company Inc., et al.
Index No. 82-0196

Dear Mr. Murray:

Pursuant to my telephone conversation yesterday with you and Peter Clark, I am enclosing documents numbered 338726 through 329917. You may undoubtedly already have copies of many of them.

Sincerely,

Thomas F. Curnin

Albert R. Murray, Esq.
Assistant U.S. Attorney
Middle District of Pennsylvania
Post Office Building - Room 426
Washington & Linden Streets
Scranton, PA 18501

[Enclosures]

VIA FEDERAL EXPRESS

cc: Robert W. Ogren, Esq. (without enclosures)
Peter B. Clark, Esq. (with enclosures)

12-20
P Clark

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WRITER'S DIRECT NUMBER
(212) 701-3609

March 29, 1985

Re: In re Grand Jury Investigation
E.F. Hutton & Company Inc., et al.
Index No. 82-0196

Dear Mr. Murray:

I am enclosing herewith documents numbered 329918 through 331366 and documents numbered 332506 through 332527. You may undoubtedly already have copies of many of them.

Sincerely,

Thomas P. Curnin

Thomas P. Curnin

Albert R. Murray, Esq.
Assistant U.S. Attorney
Middle District of Pennsylvania
Post Office Building - Room 426
Washington & Linden Streets
Scranton, PA 18501

[Enclosures]

VIA FEDERAL EXPRESS

cc: Robert W. Ogren, Esq. - without enclosures
Peter B. Clark, Esq. - with enclosures

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WRITER'S DIRECT NUMBER
(212) 701-3609

April 9, 1985

Re: In re Grand Jury Investigation
E.F. Hutton & Company Inc., et al.
Index No. 82-0196

Dear Bob:

Enclosed are the redrafts of the proposed Plea Agreement, Information and Complaint received yesterday. I have noted our suggested changes directly on your drafts for ease of reference. Please let me have your comments as soon as possible so that the "final" drafts can then be reviewed with the Company.

Further, I believe that we have reached substantial agreement with Al Murray on the content of the restitution formula set forth in Schedule I.

Sincerely,

Tom Curnin

Thomas F. Curnin

Robert W. Ogren, Esq.
Chief, Fraud Section
U.S. Department of Justice
315 9th Street, N.W.
Washington, D.C. 20006

[Enclosures]

561

cc: Albert R. Murray, Jr
William G. [illegible]
Thom[illegible]
, Esq.

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WRITER'S DIRECT NUMBER
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April 9, 1985

Re: Grand Jury
(E. F. Hutton & Co.)

Dear Al:

Enclosed, as we discussed, is a redline draft of the restitution procedures, which reflects the changes we agreed on yesterday and today.

Sincerely,

Edward P. Krugman

Albert R. Murray, Jr.
Assistant U. S. Attorney
Federal Building
Third & Walnut Streets
Harrisburg, PA 17108

[Enclosure]

VIA FEDERAL EXPRESS

cc: Thomas F. Curnin, Esq.
Thomas J. Kavaler, Esq.

Mr. TROTT. Mr. Chairman, could you just identify that for us? What is that?

Mr. HUGHES. That is correspondence, mostly during the spring of 1985, between counsel and Mr. Ogren primarily, but others, with Mr. Murray's copy of the correspondence dealing with some of the discussions concerning E.F. Hutton case, mostly among counsel and the Justice Department.

Mr. LUNGREN. Might I resume, Mr. Chairman.

A little while ago there was some question, a number of questions posed to you with respect to other practices, and where the Department was aware of other similarly situated firms acting in the same way.

Let me frame it this way. After the Hutton plea was made public, did the Department of Justice receive any complaints from banks regarding cash concentration activities on the part of other entities?

Mr. CLARK. What type of complaint, sir? Complaints that the restitution program was not sufficient?

Mr. LUNGREN. No, no. What I was asking is whether they had any evidence or thought they had any evidence to suggest to you that you might check into other entities outside of E.F. Hutton for similar activities.

Mr. CLARK. We received a substantial number of letters after the 5th of May. My recollection is—and I have not reviewed them recently—my recollection is that most of the letters dealt with complaints that individual customers of Hutton and the other brokerage firms had with respect to slow payment and remote disbursement.

Mr. LUNGREN. I understand. Were there any other complaints brought to your attention that you felt justified investigation by the fraud section with respect to similar activities on the part of other individuals or entities?

Mr. CLARK. One comes—there may have been a couple. One comes to mind that involved a lead that we sent to the Postal Inspection Service. They followed it up, conducted an interview or two and reported back that there was no substance to it.

Mr. LUNGREN. Earlier you mentioned—I think three of you made reference to the 1984 Comprehensive Crime Control Act, particularly with reference to the bank fraud sections, and the fact that that covers activity which was previously uncovered, and in that light, could you mention for the record the substantive activities that you thought were improper, which you included in your injunctive relief, but which you were unable to prosecute criminally because of either the absence of those changes in the bank fraud statute, or absence of other legislation, that you might deem it important for us to get on with?

Mr. OGREN. Mr. Lungren, the principal activity was the basic drawdown sheet multiplier or formula that Hutton was using. We believed that that practice was encompassed or would be encompassed under the new bank fraud statute, but not prior law.

The crisscrossing of checks, the daylight overdrafting practices, one we believed would be covered, that is sort of a classic kind of kite-type situation that *Williams* clearly knocked us out on, and then I think possibly with a little less clarity, but we feel confident that we can press this as the issue of retarding collection for purposes as a fraudulent practice for the purpose of obtaining the benefits of generating float in that manner. So I would say those three practices were the principle ones.

Mr. Lungren. Those three practices were covered by which?

Mr. Ogren. Were covered by the injunction, and by the bank fraud statute could not be covered by mail or wire fraud.

Mr. Lungren. What about the point the Chairman made earlier, that it sounds like it is important but that injunction obviously only goes toward controlling the parties to the suit.

Mr. Ogren. Well, that is true of all injunctions, but that is the way enforcement actions in this country are handled. The SEC, CFTC, whatever, that is the way they announced their positions with respect to the law. They bring an enforcement action, and the world understands what its problem is.

Mr. Lungren. I guess my question is this. You sent that set of signals, as I understand it?

Mr. Ogren. Correct, sir.

Mr. Lungren. To the communities similarly situated. What precisely was the signal you wanted to send, and what did you want them to do in response to that?

Mr. Ogren. The signal that I believe was sent—and I think you have to be almost blind not to see it—is that a drawdown practice involving a multiplier or formula involving uncollected funds is not only a bad practice, it is a bank fraud in violation of 18 U.S.C. 1344. It is a criminal matter. We happened to deal with it in a civil setting, but that is an expression with I think ultimate clarity that we view that to be a crime.

Mr. Lungren. Let me be precise on this. What I am trying to figure out is, were you, in the injunctive relief area of the plea bargaining agreement, attempting to put people on notice that the subsequent changes in the bank fraud statute would now cover those activities?

Mr. Ogren. Yes, sir.

Mr. Lungren. So that in the future it wouldn't just be injunctive relief that you could get them to agree to, it would be those type of actions now covered under Federal law, and it was your best signal of showing everybody that is what you intended to do, even though you couldn't do it with the substance of the activities committed by E.F. Hutton, because at that time we didn't have the change in the law?

Mr. Ogren. That is absolutely correct.

Mr. Lungren. Is that correct?

Mr. Ogren. Absolutely correct.

Mr. Trott. Mr. Lungren, the point that the injunction only binds Hutton is somewhat of an obvious point. Any prosecution of a burglary only puts that burglar in jail but hopefully it sends a message to everybody else who is thinking about committing a burglary.

Mr. Lungren. If the law hadn't been changed your message couldn't have been very strong, because someone else, I guess good counsel would take a look at it and say, "Hey, they didn't have the law."

Mr. Trott. That is absolutely accurate.

Mr. **LUNGREN**. Are there any other substantial changes in the banking fraud statutes that you think are necessary at this time, or do you think the changes we made last year by and large take care of the problems that you saw from the case developed by Mr. Murray?

Mr. **OGREN**. Well, of course, we haven't tested our theory in the litigated setting. We think, and we are confident, that it will hold up. I am happy with that statute.

I think it is an excellent statute. I think it was a great thing to do. I am pleased.

Mr. **TROTT**. I agree with Mr. Ogren.

We think it is a solid statute and it gives us a lot more fire power in this area.

Mr. **LUNGREN**. Let me just ask one other question, prompted by the comment of Mr. Murray last week. In which he said you had in this circumstance banks that were presumed victims of the scam, and yet I am not sure what words he used but I would use the words "acquiesced in," they acquiesced in the actions of future—presumably because it is a large firm, had a lot of money, and you didn't want to offend them.

To what extent did that fact situation cause difficulty in pursuing a case against either individuals or the corporate structure, if you didn't have the plea bargaining agreement, or didn't that enter into it at all?

Mr. **TROTT**. It did, and Bob can be more specific, but you had a situation where you had all varieties of "victims." You had some who came in screaming saying, "We are being defrauded." You had others that didn't want to be embarrassed, and said, "Oh, no, no fraud. This is all fine with us."

So, you had a situation where you had people similarily situated with a completely different view of the case. In a litigation posture this would have raised considerable problems.

Mr. **OGREN**. I think that is correct. We were concerned about the way the cross-examination of the bankers would go. They would appear to be, they would appear to have had some knowledge of what was going on or negligence, and it was a setting in which one could easily specify some injury nullification.

Mr. **LUNGREN**. Thank you, Mr. Chairman.

Mr. **HUGHES**. The Chair recognizes the gentleman from Connecticut for 10 minutes.

Mr. **MORRISON**. Thank you, Mr. Chairman.

I would like to follow up on the civil injunction a little further, and some of the details of it, and so if you would have a copy of it available to you, which I believe you do, it would be helpful.

In article 2, of section 2, of that starting on page 3, there are seven numbered paragraphs, which are the seven practices that are prohibited under the injunction.

First of all, is it your belief that those seven practices define the criminal law, that is to say, that you would prosecute any appropriate potential defendant who did something that violated that standard, under the criminal law?

Mr. **OGREN**. With the exception of No. 1, which is purely remedial, that is in this instance we put in a provision that required

Hutton to make disclosure. They have to disclose, and that is because they hadn't, and because they ripped off the banks.

We felt that as a remedial measure that ought to be in.

Mr. **Morrison**. Are you saying that it is not required that you disclose your practices to banks?

Mr. **Ogren**. I think what we have here is that it requires that they disclose all of their money management practices, not specifically the overdrafting, so even the basic drawdown system, and how to expect to use it, has to be disclosed. That is what No. 1 reaches, and it is broader than simply overdrafting it.

It goes to their full money management practices.

With respect to 2, 3, 4, 5, 6, and 7, that largely deals with creating float, drawing against unchecked funds, drawing against noncustomer deposits. To some extent, it is fact bound; but, yes, the short answer to your question, is, yes, we believe that those activities would be criminal.

Mr. **Morrison**. which of those two through seven paragraphs are based on the new statutory authority, and which of them on the old?

Mr. **Ogren**. Well, actually they are all on the new now. I mean they are clearly coverd by the banking fraud provisions.

Mr. **Morrison**. Let me ask it a different way. Which things do you believe were prosecutable before the new statute, and which could you only have prosecuted now under the new statute?

Mr. **Ogren**. Under mail and wire fraud, only paragraphs 2 and 3; and under the new banking fraud statute, paragraphs 4 through 7.

Mr. **Morrison**. Now when was it that to the best of your knowledge anyone of the three of you, when was it that Hutton stopped each of the practices covered by 2 through 7, if they ever stopped them?

Mr. **Ogren**. Well, I think they stopped 4 through 7 when the injunction was entered, although it may be that No. 7 on the crisscross had stopped somewhat earlier, but basically the purpose of the injunction was to reach 4 through 7, because those were threatening to continue.

With respect to 2 and 3, they stopped about the time alleged in the information, at least on a widespread basis.

There have been scatterings of that occurring afterward, but that largely was confined to the period charged in the information.

Mr. **Trott**. Maybe Mr. Ogren should elaborate what he means by 4 through 7 were threatened to go forward, and you say what Hutton told us about it.

Mr. **Ogren**. Yes, we met with Hutton's lawyers. They not only asserted their innocence, they said we are going to put this process of multipliers and formulas in a computer and we are going to really do it now, fellows.

In short, they throw down the gauntlet on the floor, and they said we are not only innocent, we are going to expand this, and we are going to take this national on a computerized basis.

And I want to tell you I was terrified when I heard that, and it seemed to me that we had to come to grips with this problem because of the dollars involved.

Mr. **Morrison**. So your testimony is, your belief is that Hutton stopped, had basically stopped doing 2 and 3 but was doing and was threatening to continue doing 4 through 7?

Mr. **Ogren**. Yes, and, as I say, subject to the possibility that there were some isolated instances of two and that occurred beyond the period of the information.

Mr. **Morrison**. And you understood that at that time to be Hutton's corporate policy, to have stopped 2 and 3, and to go on with 4 through 7?

Mr. **Ogren**. Correct.

Mr. **Morrison**. So between the effective date of the Crime Control Act and when this was entered into, you had significant criminal conduct by E.F. Hutton on 4 through 7?

Mr. **Ogren**. Well, it wasn't, because there was no statute in effect.

Mr. **Morrison**. What was the effective date of the statute?

Mr. **Ogren**. It started in——

Mr. **Morrison**. In 1984.

Mr. **Ogren** [continuing]. It started about the time we started negotiations or discussions with them. That is about the time.

Mr. **Morrison**. Was it in effect in late 1984; is that correct?

Mr. **Ogren**. Correct.

Mr. **Morrison**. I think it is important that you know that when Hutton testified here about these practices required under this injunction, I asked them whether or not they were at a competitive disadvantage, and whether or not they were being required to do things under this order that were significantly more stringent in terms of drawdown policy than their competitors, and they said, yes, that they did not believe that this was by any means a statement of the limits of what they had to abide by, because of their situation.

I say that to you to suggest that maybe the signal isn't quite as clear and unequivocal as you suggest, that you intended, and you may——

Mr. **Ogren**. The only aspects that I would agree with them on is No. 1. That clearly is a Hutton bound requirement.

As to the others, I think we have said again and again what our position is with respect to that, and I think all the commentators that have picked this up have our views on that.

Hutton may have private views that were reading the statute broadly, but frankly, I mean their lawyers know our position on it. We have made it very clear. If that message hasn't gotten through to their management, I feel sorry for them.

Mr. **Morrison** [continuing]. I have no further questions, Mr. Chairman.

Mr. **Hughes**. The gentleman from Florida is recognized for 10 minutes.

Mr. **McCollum**. Mr. Chairman, I am going to yield back at this point my time to the Chairman, because I really think that from my standpoint we have explored this, and I just am satisfied with what answers we have gotten, but I know the Chairman has more questions that I think he wants to ask, and I am willing to be involved in whatever way.

Mr. **Hughes**. I really don't have much more myself.

First of all, I just want to find out in addition to the memoranda that have been introduced by our colleague from California from you, Mr. Clark, which is undated, which alludes to the extension of the grand jury, with a note on it from Mr. Ogren, apparently, are there any other memoranda that is available that would bear on the subject of the extension of the grand jury?

Mr. CLARK. I don't believe so, Mr. Chairman, and I have the product of our search through Mr. Murray's files, the Department's files, and the Postal Inspection Service's files.

Mr. HUGHES. I only have one additional, just sort of housekeeping chore.

One of the statements made by Mr. Fomon was that E.F. Hutton did not commit 2,000 counts of mail and wire fraud. Did you happen to catch that statement that was made?

Mr. TROTT. Yes.

Mr. HUGHES. I wonder if you can enlighten us as to whether or not there were 2,000 counts of mail and wire fraud?

Mr. CLARK. There certainly were. I believe Mr. Fomon was misinformed.

Mr. HUGHES. And there is no question but that the 2,000 counts represented activities, each a different offense, 2,000 offenses on either separate occasions or different events that represented violations of the mail and wire frauds?

Mr. CLARK. That is correct.

Mr. HUGHES. So the suggestion that the 2,000 counts was just crafted to get the fine up to $2 million is not accurate?

Mr. CLARK. Well, you had to have 2,000 counts for a $2 million fine.

Mr. HUGHES. I understand that, but the suggestion was that you worked from a $2 million fine.

Mr. CLARK. Well, in effect, we did, but if there had been an agreement of a $1 million fine——

Mr. HUGHES. Are you suggesting, was there more than 2,000 counts, instances that could have been charged?

Mr. CLARK [continuing]. Yes.

Mr. HUGHES. Can you give us some idea of how many?

Mr. CLARK. The postal inspectors were ready with a list of an additional 1,000 to 1,500, as I recall, and frankly, when the computers had cranked out 3,500, there wasn't any point in keeping on going.

Mr. HUGHES. Can you tell me just for my own information and for the record, do you have any estimate on the amount of the fraud?

Mr. Murray suggested it could be anywhere from $15 million to $250 million.

Mr. TROTT. I certainly don't.

Mr. CLARK. Mr. Murray, Mr. Chairman, and John Holland are the two people most familiar with the evidence in this case.

Mr. HUGHES. Can you tell us how——

Mr. CLARK. In the seven months that I participated in the investigation, I reviewed everything I could get my hands on, but I did not sit down and try and tabulate, because we would not have indicted for more than what we could indict for in the Middle District of Pennsylvania, and that probably would have been a maximum of 500 counts.

It was an exercise in futility to try and tabulate. You get tired.

Mr. **Hughes** [continuing]. Did anyone at Justice share the belief of Mr. Murray that use of the drawdown sheet in itself was a violation of the law?

Mr. **Clark**. Well, we all believed it is a violation of 1344, but 1344——

Mr. **Hughes**. Today?

Mr. **Clark** [continuing]. I am talking about then. I am talking about the counts in question, the period from the 19th of July of 1980 until December or thereabouts of 1981.

Mr. **Ogren**. Not only did no one agree with that position, but Mr. Murray did not hold that view, sir, in any meetings that I attended when we evaluated the evidence. I am not sure what is the basis of your saying that, but he never said it to me.

Mr. **Hughes**. I believe Mr. Murray testified that he felt that the use of the drawdown sheet in itself was a violation of the mail and wire fraud.

Mr. **Ogren**. Well, you know, absent the *Williams* case, I think we might have had a shot at it or *Frankel*, but that was our basic impediment, because you couldn't use the theory that we were using which was an abuse of the customer relationship.

That was a little bit askew from that. I never understood him to hold that view. He shared the view that Peter and I had, that we were in trouble on the drawdown sheet as a theory under the mail and wire fraud statute which is one of the reasons why we thought to go with what we thought was a cleaner, narrower cleaned down case.

Mr. **Trott**. He is here if you want to ask him on that subject.

Mr. **Hughes**. His testimony, I think, in that regard is in the record. The $2 million fine, can you share with us how you arrived at $2 million? Obviously, it is a matter of bargaining, but here we have a case that involved anywhere from $15 to $100 or $250 million, depending upon how you calculated the interest profits during this period of time.

And one of the criticisms that one often hears is that the fine is disproportionate to the amount of the offense.

Here we have a corporation that was engaged in extensive, humongous criminal activity, that made, obviously, tens of millions of dollars in interest profits illegally, and the fine is $2 million.

Mr. **Trott**. Mr. Chairman, the amount per count, I believe, at the time of the offenses in question was $1,000, is that correct, Mr. Ogren?

Mr. **Ogren**. Yes.

Mr. **Trott**. The new law—by the way, again, the Comprehensive Crime Control Act fixes another problem.

The amount of fine per count now is substantially more, but at the time it was $1,000 a count. We wanted to get a substantial fine that somehow we hoped would represent to the American public the magnitude of this.

I guess I am the author of the 2,000 counts, because I wanted to make it apparent that it was widespread, and Bob sort of felt that $2 million—we also generally felt $2 million was a good figure. So at one point we tried to say, well, maybe we can use 20 counts but stipulate that the fine will be greater, but we would have been writing the law, so we came to the conclusion that we had a supportable 2,000 counts.

Two million dollars was a rational figure, and orderly Federal indictments or informations contain no more than 20 counts.

Some judges get absolutely furious at any documents that contain more than that amount of paperwork, so we finally decided, and we tailored this so that it didn't take up a lot of——

Mr. HUGHES. Of course, this is not the usual case.

Mr. TROTT. No; that is why we went for 2,000 counts.

Mr. HUGHES [continuing]. So, in essense, the number of counts is what dictated the amount of the fines.

Mr. OGREN. Yes. We actually reached the amount of a $2,000 fine first. Then we went to the counts we could prove. Mail and wire fraud, we felt, was the only available option. We went that way.

I would just like to add one thing about the fines. Your committee is in a position to do something about this problem. This was a problem we faced during the course of the investigation.

How do you come up with a decent fine in a case like this with these archaic fines that exist on the books? Congress did change the law and upped it to $500,000 for a corporation, $1 million cap for an aggregate or a double factor; twice the gain, twice the loss.

I think the $1 million is still too low, and that is the maximum we are actually operating under.

In fact, if this case were brought today, the only way we could get over the $1 million under the alternative fine mechanism would be by showing to the court, and the court would have to be willing to hear us on double the gross gain or double the gross loss theory.

If it were in a litigated settling, we would be in trouble. In a consensual setting, we would be able to get away with it. I don't think it is a realistic number, and I think it is about time Congress put some realistic fines in place in regard to these corporations.

It is ludicrous. This is what you get. You get people reaching a result. You say how come only $2 million, Congressman, if you wanted 10? We would have had a 10,000 world count. The Guiness Book of World Records would have been——

Mr. HUGHES. Mr. Ogren, I can only tell you we had the fines provided by the Justice Department.

Mr. OGREN [continuing]. They are an improvement.

Mr. HUGHES. We did make a number of improvements. The fine for a high-level drug trafficker was $25,000 up until the Comprehensive Crime Control Act, and we have increased the penalties significantly, and developed the alternative fine provision as well as some new forfeiture provisions. But in the final analysis, the final schedule that we followed was fairly much supported by the Justice Department.

Mr. TROTT. Don't mistake what we say. We are going to try to prove it and get larger fines.

But I think what Bob is pointing out is it could even be easier yet with larger fine maximums.

Mr. HUGHES. The gentleman from California.

Mr. LUNGREN. I now have the document in front of me entered in the record that we made reference to before. As it reads:

Bob, according to Al Murray, Steve Trott was asked by Dave Queen to call Ken Fletcher, the Chief Postal Inspector, to request that the Postal Service maintain their level of commitment on the Hutton case during the period that the grand jury will be extended.

You read some of the bottom parts of it a little bit earlier. The reason I mention that is I find it interesting that three of the principals involved—Murray, Trott and Queen—according to this report, or this memo, were acting on a request assuming that the grand jury was to be extended.

Mr. CLARK. That is correct.

Mr. LUNGREN. And, to me, that is as important as the bottom lines that you mentioned.

Mr. CLARK. Yes.

Mr. LUNGREN. Where you said you are going to file the motion to extend the grand jury's term.

Evidently, the three named had to know about that decision and were acting on that assumption to try and protect the case in terms of the level of commitment that they received from the Postal Service.

Mr. CLARK. As I indicated, Mr. Lungren, and as Mr. Murray indicated in his testimony last Friday, he began discussions with Dave Queen, as U.S. attorney, probably a month ahead of the date on which we applied for the extension.

Mr. LUNGREN. I appreciate that. Thank you very much.

Thank you, Mr. Chairman.

Mr. HUGHES. I just want to say that that is understandable. The case, as I recall, was presented to a previous grand jury. This was not the first grand jury.

Generally speaking, extending the grand jury does present some problems. Not every judge will want to continue a matter. It doesn't happen very often. But it does happen that judges turn down requests for extensions of grand jury, although that is unfortunate—the case of this complexity, where you have grand juries that are conversant with it.

But I think the document is significant. And, according to the testimony, it does pinpoint to December 14. There will be some testimony now from Mr. Fomon and Jay Moorhead insofar as the luncheon and the notice on the luncheon, which apparently were the requests for the meeting was communicated before the 14th.

And the question becomes, what was communicated to the Justice Department?

In any event, I have no further questions on this line, and we do have a subpoena to take up unless my colleagues have some questions.

Mr. TROTT. Excuse me, Mr. Chairman. Are Mr. Trott and Mr. Ogren excused?

Mr. HUGHES. Yes. Thank you very much. You are excused.

Mr. Trott, the return day on the subpoena is today, as you know, and I wonder if you can tell us at this time whether you are prepared to comply with the subpoena.

Mr. TROTT. Mr. Chairman, as indicated in the submission filed with the judge up in the Middle District of Pennsylvania, we have requested some guidance from the judge. Unfortunately, as of this date we have not received any.

I understand that counsel for the House has been in communication with the judge, but in talking with Mr. Gregory yesterday I still don't know what the position is going to be that you will take.

We believe that as of this juncture, we have complied with everything that we are under the law capable of complying with. To my knowledge, we have given you all of the deliberative documents that we have in our files and everything else that we can without violating 6(e), or further direction from the court.

Mr. HUGHES. There are a number of documents that we have requested, for which 6(e) has been exercised. And it is your contention today, as it has been consistently, that the documents that we requested—but you have not furnished us—that have been subpoenaed are privileged documents under 6(e).

Mr. TROTT. I had a discussion with Mr. Gregory on a couple of occasions regarding category III. And, to my knowledge, Mr. Clark and Mr. Landers, who is sitting at my right, who was designated at the very beginning in this case as the coordinating person on this, have combed all files in existence in the Justice Department looking for memoranda, reports, letters, internal communications, et cetera, and we have turned all those over to the extent that we can under 6(e).

I asked Mr. Gregory what else; is there something we are missing; do you want my phone logs, my calendars? And he told me, no, those weren't included in there.

To the best of my knowledge—and I personally am not the one that went through the filings; other people did—Mr. Clark and Mr. Landers did—we have turned all those over.

Is that correct, Mr. Landers?

Mr. LANDERS. That is correct.

Mr. HUGHES. For instance, one of the things that we sought for some time and have not received, are the ledgers on the zero-balance account, for instance, over which you have exercised 6(e). That is the critical time in question from July 1980 through December 1981, a 6-month interval in there we do not have those documents and which are essential for us to complete our investigation. Is it your contention they are covered by 6(e)?

Mr. TROTT. Yes. And I thought this was subject to the Congressman Mazzoli fix. Hutton had access to these and would be able to turn them over.

Mr. HUGHES. We have not gotten that information. They are covered by our subpoena, and we have not received that information. We have checked there. There was some suggestion at the last hearing we should have that information, but we do not have it.

Mr. TROTT. This is some of the material we are asking for direction from the court on. Mr. Chairman, I honestly, and I hate to say that, because I hope everything I say is honestly, but I am between the proverbial rock and a hard place on this. I understand the committee's interest in this information, but by the same token, I am bound, as an officer of the court and representative of the Federal Government, to respect 6(e).

I can tell you it is my considered judgment we have made honest judgments on the 6(e) issue, you and I respectfully differ on that. And we have turned in the appropriate direction to the court for guidance. I can either get in trouble with this committee, which I don't want to do, the judge, which I don't want to do, and the judge has been so advised.

Mr. HUGHES. Let me ask you this with respect to 6(e)—6(e) permits the Government to reveal secret grand jury materials to certain persons, for example, to Government personnel who are assisting the prosecutor, and an attorney of the Government, in the duties of the purview of such attorney's duty. Are there any other exceptions you are aware of?

Mr. TROTT. We can turn it over now to State and local law enforcement. This is a result of a rule I got through the Criminal Procedures Committee. We are able to take 6(e) material that takes implementation of State law violations and with the approval of the Assistant Attorney General, we can turn that over. That is new.

Mr. HUGHES. Are there any other exceptions, to your knowledge?

Mr. TROTT. Well, we have tinkered with a theory that the court has some inherent power to do this, but that is not our power.

Mr. HUGHES. No; I am talking about exceptions. I am going to show you document B-1, which I offer for the record. Is there objection? Hearing none, it is admitted.

[The information follows:]

U.S. Department of Justice

United States Attorney
Middle District of Pennsylvania

Room 426 - Post Office Building
Washington & Linden Streets
Scranton, Pennsylvania 18501

717/961-2924
FTS/592-8301

August 10, 1984

Thomas F. Curnin, Esq.
80 Pine Street
New York, New York 10005

Re: U.S.A v. E. F. HUTTON GROUP, Inc., et al.

Dear Mr. Curnin:.

This letter will briefly commemorate our recent meetings in regard to the on-going grand jury investigation being conducted in the Middle District of Pennsylvania; as such inquiry relates to your clients E. F. Hutton, Group, Inc., et al.

1st: On April 4, 1982 our office forwarded to your attention a proffer letter in anticipation of commencing plea negotiations, which letter contained a five page attachment specifying the particular statutes and areas of the Grand Jury's inquiry. A response to this proffer letter was not received during the requested time nor an extension requested. Thereafter, in May of 1984, you indicated you would or could not respond thereto because of a misunderstanding but alternatively, requested a meeting.

2nd: An initial meeting between counsel was held in Harrisburg, Pa on July 6, 1984, at which time counsel for the government and Hutton respectively:

A) Discussed the Government's theory of prosecution.

B) Discussed the grounds for the offense.

C) Discussed proposed plea-bargain terms, as they relate to potential corporate and individual defendants.

D) Failed to agree on a pre-indictment disposition to the grand jury's investigation.

3rd: A second meeting between counsel for the government and counsel for Hutton, et al., was held on Friday August 3, 1984; at which time the following was discussed and reviewed:

A) Waiver of the government's requirement that the letter agreement of April 4, 1984 be executed.

B) The theory of prosecution.

C) Seven areas of fraudulent conduct the government avers are violations of federal laws by Hutton, et al.

D) Specific statutory violations.

E) Government financial flow charts (computer generated).

F) Further discussion of defense strategy and exculpatory evidence.

G) Calculation of monies associated with alleged fraudulent conduct of Hutton, et al.

H) Plea bargain discussions regarding pre-indictment disposition relative to corporate and individual potential defendants.

I) Both parties failed to agree upon a disposition of the grand jury investigation pre-indictment.

4th: A third meeting between counsel was held on August 10, 1984 at which time counsel for Hutton, et al. was allowed to review the following documents:

A) Proposed grand jury indictment against Hutton, et al.

B) Prosecutive memorandum.

C) Financial computer charts.

D) Prosecutorial charts generated by potential witnesses.

E) Internal bank correspondence subpoenaed by the grand jury.

F) Miscellaneous grand jury documents.

G) Various reports of examinations conducted by federal and state agencies.

H) Transcripts of witnesses appearing before the federal grand jury sitting in the Md of Pa.

I) Specific calculations required for restitution, (pre-indictment).

J) Both parties failed to reach an agreement as to a pre-indictment disposition of the grand jury's investigation.

Our office believes that it has provided evidentiary materials both documentary and testimonial of sufficient quality and quantity to enable counsel for E.F. Hutton Group, Inc., et al. to intelligently advise the potential defendants of the nature of the Government's investigation and its possible outcome. Not only has our office waived many of its normal internal policies, but has entered into pre-indictment negotiations without the required execution of the proffer agreement of April 4, 1984.

Thank you for your cooperation.

Very truly yours,

DAVID DART QUEEN
United States Attorney

Albert R. Murray
ALBERT R. MURRAY, Jr.
Assistant U.S. Attorney

cc: David Dart Queen
United States Attorney

Robert W. Ogren,
Chief, Fraud Section
Criminal Division

Bernard V. O'Hare, III
Asst. U.S. Attorney

John Holland, Postal Inspector ✓

Thomas Dagely

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Mr. Hughes. It is a document, it is B-1 in my colleague's book, B-1 as in B-1 bomber. It is dated August 10, 1984, from Assistant U.S. Attorney Al Murray to Tom Curnin. It says the Government turned over to Hutton the following material: One, a prepared indictment, which I note this subcommittee has under subpoena and which the Department has refused to provide for us; financial computer charts and prosecutorial charts generated by the potential witnesses, which I note this committee has asked for, asked for this past June, and which the Department has refused to produce; internal bank correspondence subpoenaed by the grand jury, and miscellaneous grand jury documents identified as being subpoenaed by the grand jury and which could not reveal the workings of the grand jury; the variance reports of Federal and State agencies, which I note this subcommittee has been requesting since last June and which the Department has not produced, and, finally, and this puzzles me, transcript of grand jury witnesses' testimony, which is the essence of what rule 6(e) protects.

Can you tell me on what basis, if they were delivered to Mr. Curnin, they were delivered to him; and, second, on what basis the Justice Department would have at this time to refuse to deliver them to this committee?

Mr. Trott. Mr. Chairman, I have not seen this letter before.

Mr. Hughes. Why don't you take some time and read it.

Mr. Trott. Mr. Murray can explain exactly what was done, what this refers to, and the doctrine that grand jury material, or semi-grand jury material, can be used by the lawyer working on the case to continue to prepare and present the case, and that is what he was doing here. I think if you wish, he can go through each category and tell you what was done and not done.

Mr. Hughes. I don't know that is going to be necessary, to tell us what was done. My concern is there are no exceptions in the rule to provide this kind of material to counsel. You have exercised 6(e). If it is 6(e) for this committee, it has got to be 6(e) for the world, except for the people excepted in the statute.

Mr. Trott. I am satisfied with the way Mr. Murray summarized it for me, he was doing it without violating 6(e). He tells me the transcripts were not given over. A lot of this——

Mr. Hughes. I heard of not just delivering the transcript. Grand jury secrecy, as I understand it, requires the material to be made secret. That means you can't permit people to review it except for those who have access to it, that means you can't deliver it to them, that means you can't in any way disclose it. I don't know of any other exceptions except for the excepted class of individuals.

Now the concern I have, Mr. Trott, is that you have exercised 6(e) on a universe of documents here that have been made available to other people who are not people that are defined by statute as being entitled to it. And this committee has made a request to complete our investigation, and you refused to turn that material over to this committee.

Mr. Trott [continuing]. Mr. Murray just whispered in my ear that is not what happened. He would like to explain it. I am advised there is a doctrine that says you can use this material to continue to talk to witnesses and prepare and perfect your case. Otherwise, what good is it?

Mr. HUGHES. Just answer this question for me, Mr. Murray. Was either this material turned over to Mr. Curnin or was he permitted to inspect this material?

Mr. MURRAY. I have to give you a full explanation.

Mr. HUGHES. Yes or no. You can answer that yes or no.

Mr. MURRAY. Excuse me, I don't think I can, because it will mislead you. I don't want you to get a conclusion that is not what exactly happened.

Mr. HUGHES. My only question is whether or not this material was made available to Mr. Curnin.

Mr. MURRAY. Mr. Curnin was not allowed to read any transcripts of any grand jury witnesses in this case. He was allowed to read one transcript at one point in time, and that was in relationship to a witness who testified before the grand jury that he represented that perjured himself, I believe may have perjured himself, and desired to come back into the grand jury for recantation.

Mr. TROTT. That is standard practice.

Mr. MURRAY. The rest of the documents, many of the documents that you see on here represent an internal memorandum generated by Hutton. Hutton was a putative defendant. That putative defendant, in order to discuss plea bargain agreements, we discussed the material. What I generally do is I do not disclose the actual names of the witnesses appearing before the grand jury, nor do I disclose exactly where it came from. What I do disclose is we have this type of evidence, and this is what this type of evidence relates to.

Mr. HUGHES. Let me read what this correspondence would suggest, you made available to them a proposed indictment——

Mr. MURRAY. Let me explain to you what that is. That was the document I said I prepared as my own document to show the universe of—a universe, any plea agreement negotiations. I use that for one purpose, to scare an attorney——

Mr. HUGHES [continuing]. I understand. But you have refused to give that to this committee.

Mr. TROTT. I did not give that to them.

Mr. MURRAY. I did not give that to them.

Mr. HUGHES. We were not permitted to review that.

Mr. MURRAY. I will explain that. What I did was have a document prepared and said, "Tom, you can look at certain portions of my work product which I took"—that would be a proposed—maybe a proposed document. That is what I let him look at.

Mr. HUGHES. How about the prosecutorial charts?

Mr. MURRAY. Oh, he wanted them to know the evidence that we had. What I did was I showed him rough copies and computer generated information regarding evidence. When a man is asking me, "I want to know why you want my client to plead guilty," I sure have to show them some reason. I can't sit and whistle Dixie, I have to say "Here is what"——

Mr. HUGHES. How about internal bank correspondence subpoenaed by the grand jury?

Mr. MURRAY [continuing]. I did not disclose to him the nature of banking institutions in which those documents were generated. Plus, those were documents taken from Hutton's records.

Mr. TROTT. The point of this was to perfect the investigation and proceed with it, which is a standard use which, in my understanding, does not violate 6(e). You can't have the grand jury stuff in a vacuum. You have to be able to work it. If it is suggested there is a witness, and the witness can testify X, you get in the witness, and in preparing the witness you don't say, "How are you? What is your name? I am going to take you blind into the grand jury." You utilize the information——

Mr. Hughes. The point is, we were denied access to any of this material.

Mr. Trott [continuing]. Mr. Chairman, it has never been my intention to wrongfully deny access to any material. That is why I will again suggest—and I don't know for how many times we have done this—that we go up and get direction from the judge so the Department of Justice is not in the middle on this, exactly as we did over with the Senate in Alexandria on the last case. The Senate got additional information.

With all due respect, I fail to see what this committee is worried about in going to the judge and asking for guidance.

Mr. Hughes. We are before the court. You have taken it to the court, and I think in the proper ways from your perspective. We have a process we have to follow, and we are following that process, and our process is to subpoena the material. And we have a process we have to follow.

I have talked to the ranking Republican, Mr. McCollum, and we propose this solution, because I recognize the position you find yourselves in. I want to be reasonable. I want a resolution of the matter. I want to gain access to the documents so we can complete this investigation.

I suggest that we continue this return day until the 21st of January. It would be my suggestion that—I don't believe we are back here until—during that period of time, that we will be in touch with the court. We have already been in touch with the court. Counsel has been in touch with the court. And it would be my expectation—I am going to recommend to counsel that counsel challenge the jurisdiction of the court, and also offer a submission on the merits so that the court can have both, and address both the question of jurisdiction as well as the merits of the case as to whether it is 6(e) material.

Mr. Trott. I commend the chairman. I think that is a move in the right direction. In the meantime, we do understand that Hutton remains available with high-speed copiers to copy documents up in Pennsylvania.

Mr. Hughes. It would be my hope it could be resolved in a shorter time than that. But, obviously, we are not going to be in session. It would not be realistic to think I could get a quorum, first of all, between now and then. Certainly, the matter should be resolved within a matter of a few weeks, I would think.

It would be my hope that Justice be given an opportunity by the court, and it would be my suggestion to House counsel that they request of the court that Justice be permitted to brief the issue of jurisdiction as well as the issue on the merits; that we have several weeks in which to respond to that, following Justice's submission, so that it would give the court an opportunity to address those issues.

Mr. McCollum. Mr. Chairman, if I might, I agree with the procedure at this juncture. You and I have not agreed, and still don't, on some of the fundamental questions as to the necessity of the House going through the process the way we are.

I know we have to break. I am in favor of the procedure and hope we can resolve it quickly.

Mr. Hughes. Why don't we recess for a few minutes, and we will come back so we can complete this and make sure we understand what we are talking about.

[Recess.]

Mr. Hughes. The subcommittee will come to order.

I think we have an understanding. Technically, you have failed to produce the documents that we have subpoenaed and refused to do so, exercising your privilege under 6(e). So, technically, you would be subject to a contempt citation by this subcommittee.

At this time, what I am going to do is I am going to continue this hearing on the return day until the 21st of January, which is when we contemplate being back from our December recess. In the interim, I am going to request the House counsel to notify the court that we will be submitting a brief, following the submission of a brief by Justice on the question both of jurisdiction and the merits of your exercise of 6(e).

It would be my hope that we could have a few weeks to respond to Justice's brief. I would hope in the interim, so that we don't lose any time, that Justice have these documents ready to be produced in the event they are produced.

This investigation has gone on about 3 months beyond what it should have now because of the controversy over documents, so that we can complete the investigation.

Is that agreeable?

Mr. Trott. Mr. Chairman, I think if you look very carefully at the submission we have already filed up in Pennsylvania, it meets the requirements that set out that we file a statement of jurisdiction, and on the merits, already. I am not sure what else we could add to that.

The jurisdictional issue is covered. We can file something on the merits, and we will do that very soon.

Mr. Hughes. If we can do that so that can be done expeditiously. Is it your feeling that can be done within the next week to 10 days?

Mr. Trott. Yes. And we will make every effort to do it even sooner.

If I can make one correction, we don't look at this as a privilege under 6(e) that we have exercised. We see it as an obligation that covers us and describes our responsibilities.

Mr. Hughes. I think we know that you have exercised the protections afforded under 6(e) for grand jury secrecy. And if you can have the documents that we requested assembled so that they can be readily produced in the event this committee is given access to those documents, that would help expedite the balance of this investigation.

Mr. Trott. If there is a priority that Mr. Gregory might work up, some list of documents within—you are talking of a universe of 6 million documents that are still being held in place for SEC.

Mr. Hughes. I wouldn't want to establish any priorities. I don't think the documents we requested really are that onerous, and they are easily identifiable.

Mr. Trott. It is not the entire universe of documents?

Mr. Hughes. The documents that the subpoena recites that we need.

Mr. Trott. We will work with Mr. Gregory on that.

Mr. Hughes. I wonder if you can produce for us the *Vaughn* index listing the documents in each category so that we can——

Mr. Trott. I didn't hear you.

Mr. Hughes [continuing]. The *Vaughn* index.

Would that be unduly burdensome?

Mr. Clark. *Vaughn* was a case in the District of Columbia having to do with the Freedom of Information Act. A subpoena by the committee has nothing to do with the Freedom of Information Act. A Vaughn index is an extremely onerous piece of work.

Mr. Hughes. It would be unduly burdensome?

Mr. Trott. Tremendously, sir.

Mr. Hughes. Let's talk about that so we can get some idea.

It is difficult to deal, as you know, with such a universe of documents in trying to get the documents that are relevant. We will try to work with you to see if you can't be of assistance to us. We are interested in those documents that we requested that will be of some assistance to us, so that we can pull them out rather quickly without having to go through the universe of documents.

Mr. Trott. If we know with more specificity, we can do that.

I have offered to Mr. Gregory, if he has a list of things, we can expedite some matters.

Mr. Hughes. Thank you very much.

I wonder if Mr. Robert Fomon and Jay Moorhead can come forward at this time so we can complete the hearing today.

TESTIMONY OF ROBERT FOMON, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, THE E.F. HUTTON GROUP, INC., E.F. HUTTON & CO., INC.; AND JAY MOORHEAD, EXECUTIVE ASSISTANT TO THE CHAIRMAN OF THE BOARD, THE E.F. HUTTON GROUP, INC., E.F. HUTTON & CO., INC.

Mr. Hughes. Mr. Fomon, welcome back to the committee. You have been here several times and we appreciate your coming back on such short notice.

We know it is not without a great deal of inconvenience you are here today. We appreciate your willingness to be here today.

Mr. Moorhead, welcome to the committee.

Let the record indicate, pursuant to clause 2 of rule XI of the Rules of the House, copies of the Judiciary Committee have clause 2, rule XI of the Rules of the House, in particular, have been made available to the witnesses and are now at the witness table.

Mr. Fomon and Mr. Moorhead, you have a right to counsel to assist you in the course of today's proceedings. Are you accompanied by counsel?

Mr. Fomon. Yes.

Mr. Moorhead. Yes.

Mr. Hughes. I wonder if counsel will identify himself.

Mr. **Christopher**. Warren Christopher.

Mr. **Hughes**. Welcome, Mr. Christopher.

I wonder if you would just rise at this time and raise your right hand.

[Witnesses sworn.]

Mr. **Hughes**. Mr. Fomon or Mr. Moorhead, do either of you have an opening statement that you wanted to make?

Mr. **Fomon**. No.

Mr. **Moorhead**. No.

Mr. **Hughes**. Why don't we begin with you, Mr. Moorhead.

Why don't you tell us what you know about the luncheon that took place at the Jockey Club on November 15, 1984?

Mr. **Moorhead**. The circumstances surrounding the luncheon?

Mr. **Hughes**. Yes. When you first became aware of it, who you talked to about it, what transpired, and especially your recollection of what you did.

Mr. **Moorhead**. In early November, Mr. Fomon asked me if I would make a telephone call to the Attorney General to set up a lunch. He explained a company was under investigation and that he wanted to go down to Washington to meet with the Attorney General.

I told him that I didn't know the Attorney General personally, but I did know Mrs. Smith personally and I would be happy to call her. He said that is fine, and invite Mrs. Smith to the lunch.

So I proceeded to call Mrs. Smith, arranged a luncheon at the Jockey Club several days later, and came down. We had the lunch and I then returned back to New York.

Mr. **Hughes**. Let me ask you, how long had you worked for E.F. Hutton at that time?

Mr. **Moorhead**. When I made the call?

Mr. **Hughes**. Yes.

Mr. **Moorhead**. I had just started.

Mr. **Hughes**. When had you started?

Mr. **Moorhead**. I don't recall the exact date I made the call, but it was either my first or second day I was there.

Mr. **Hughes**. And where had you been employed previous to that?

Mr. **Moorhead**. Previous to that I worked for the Los Angeles Olympic Organizing Committee.

Mr. **Hughes**. You say that you knew Mrs. Smith but not the Attorney General?

Mr. **Moorhead**. Not on a personal basis, no.

Mr. **Hughes**. Where did you know Mrs. Smith from?

Mr. **Moorhead**. From my association with her at the White House.

Mr. **Hughes**. When were you employed at the White House?

Mr. **Moorhead**. From January 1981 through January 1983.

Mr. **Hughes**. In what capacity did you serve there?

Mr. **Moorhead**. I served as Special Assistant to the President for Private Sector Initiatives.

Mr. **Hughes**. I'm sorry.

Mr. **Moorhead**. Special Assistant to the President for Private Sector Initiatives.

Mr. Hughes. So you became acquainted with the Attorney General's wife as a result of your employment at the White House?

Mr. Moorhead. Yes; she was on the board of an organization called Volunteer, and there was an event my office coordinated with that organization.

She was the Chairman of the organization, so we had numerous contacts setting up that event.

Mr. Hughes. On what date did you call Mrs. Smith?

Mr. Moorhead. As I recall, it was middle of November, I think around November 12. That was my first day I was there. I think that was the date, or around that time.

Mr. Hughes. And you called her at home?

Mr. Moorhead. I called her at the Jefferson Hotel.

Mr. Hughes. What did you tell her that you wanted?

Mr. Moorhead. I said that Mr. Fomon had asked me to call and that he was going to be in Washington at some time over the next several days, that he asked me to call her to see if she and her husband could get together with him at some mutually convenient place for lunch sometime in the next 10 days or so.

Mr. Hughes. And did you indicate who Mr. Fomon was with?

Mr. Moorhead. Yes; I indicated—well, she knew who Mr. Fomon was.

Mr. Hughes. She knew Mr. Fomon, I see.

Did you indicate the purpose of the meeting?

Mr. Moorhead. I said that it was to be a social lunch, but I also indicated to her that Mr. Fomon had something that he wanted to discuss with her husband.

Mr. Hughes. Some business activity of some kind?

Mr. Moorhead. Yes; I mean, I think I described it as some kind of business activity. I didn't describe it in any more detail.

Mr. Hughes. Did you tell her that it was an investigation that was underway at the Justice Department at the time?

Mr. Moorhead. No; I did not.

Mr. Hughes. You did not identify the nature of the business?

Mr. Moorhead. No.

Mr. Hughes. I see.

Who decided upon the Jockey Club? Was that something that you had proposed?

Mr. Moorhead. I can't remember. I think it was a mutually convenient place. I think I may have suggested it, she may have said that was fine.

Mr. Hughes. Did you set the date at that time or did that come about later?

Mr. Moorhead. She called me back a day after I called her, or 2 days—I am not exactly sure when—and said that the 15th, I believe, would be OK for her and the Attorney General to meet Mr. Fomon for lunch.

Mr. Hughes. I see. Is that the first time you had called Mrs. Smith to arrange such a meeting?

Mr. Moorhead. Since I left the White House; yes, sir.

Mr. Hughes. Mr. Fomon, I wonder if you can tell us what you know about the meeting at the Jockey Club on the 15th, how it came about, what took place.

Mr. **Fomon**. I think Jay has pretty well described it. We met, had what you would call a social lunch, and toward the end of the lunch, I told the Attorney General that we were under investigation by the Justice Department and that we had wanted to make some submissions to Justice in Washington and we were concerned that we would not have an opportunity to do it before the GJ expired.

And we wanted to make the submissions because we realized there was a possibility of our being indicted by the GJ, and obviously we thought if we made the submissions, it would mitigate the possibilities of being indicted.

Mr. **Hughes**. What did you tell the Attorney General that you would like him to do? What did you ask him to do?

Mr. **Fomon**. I didn't ask him to do anything. I told him that our concern was that the grand jury was going to expire.

Mr. **Hughes**. Did you ask him to extend the grand jury or have the grand jury extended?

Mr. **Fomon**. I don't know if I put it in those words. Certainly, that is what I felt he could have done for us, yes.

Mr. **Hughes**. What is it that occurred that prompted you to take those steps? Did something occur prior to that to prompt you to ask Jay Moorhead here?

Mr. **Fomon**. I was under the impression from our lawyers that we were not going to get an opportunity to make submissions to Justice in Washington before the grand jury expired.

Mr. **Hughes**. You had been before the grand jury just prior to that?

Mr. **Fomon**. Yes.

Mr. **Hughes**. Some time prior to that.

Was it something that occurred there that precipitated this approach to Mr. Moorhead?

Mr. **Fomon**. No.

Mr. **Hughes**. Mr. Moorhead was with your firm just 1 day, apparently.

Mr. **Fomon**. Well, I don't remember. It was a short period of time.

Mr. **Hughes**. What prompted you to single out Mr. Moorhead?

Mr. **Fomon**. He was my administrative assistant. He had been there for 2 hours. I would have assigned the job to him, whether he had had any prior White House experience or not. The White House experience had absolutely nothing to do with it.

Mr. **Hughes**. Did you know that he might know either the Attorney General or Mrs. Smith?

Mr. **Fomon**. I did not. But I knew Mrs. Smith, and I knew the Attorney General. He was calling in my name.

Mr. **Hughes**. Did it occur to you to call Mrs. Smith yourself?

Mr. **Fomon**. No.

Mr. **Hughes**. Did you hear back some time after that, after the luncheon meeting, from either the Attorney General or somebody at Justice or somebody else in response to——

Mr. **Fomon**. I got a telephone call——

Mr. **Hughes** [continuing]. To the concerns you expressed?

Mr. **Fomon** [continuing]. I got a call at home from, I believe it was Mr. Trott, who told me that he felt it was improper for me to be talking to the Attorney General.

Mr. **Hughes**. And when did that telephone call come about?

Mr. **Fomon**. Oh, probably—I don't know—4 or 5, 6, 7 days after the lunch.

Mr. **Hughes**. Did you hear any other response in the interim from anyone?

Mr. **Fomon**. No.

Mr. **Hughes**. At Justice or otherwise?

The Chair recognizes the gentleman from Florida.

Mr. **McCollum**. Thank you very much.

Mr. Fomon, had you on previous occasions, when you had had lunches with Mr. Smith—or had you previously had lunches with him socially?

Mr. **Fomon**. Yes.

Well, dinners. I don't remember specifically lunches.

Mr. **McCollum**. Had you gone through Mrs. Smith to arrange those, either directly or indirectly, on the previous occasions?

Mr. **Fomon**. Well, they were not while he was Attorney General.

Mr. **McCollum**. Well, what about before he was Attorney General; were they directly with him or through his wife?

Mr. **Fomon**. I don't think they were arranged with either one of them. They were arranged by other associates of mine in E.F. Hutton.

Mr. **McCollum**. Had you directed Mr. Moorhead to arrange this luncheon by specifically going through Mrs. Smith?

Mr. **Fomon**. No.

Mr. **McCollum**. What did you exactly say to Mr. Moorhead when you wanted this luncheon arranged?

Mr. **Fomon**. I don't know exactly what I said. I said that I wanted to have lunch with the Attorney General, and he chose to set it up through Mrs. Smith.

Mr. **McCollum**. Were you surprised when you learned at some point——

Mr. **Fomon**. No.

Mr. **McCollum** [continuing]. That he went through Mrs. Smith?

Mr. **Fomon**. Not at all. I mean, when you propose to have a social lunch, usually the man's wife is included, and usually those things are arranged through wives and not through husbands.

Mr. **McCollum**. Did you explain to Mr. Moorhead what you had wanted or expected to discuss with the Attorney General when you did have lunch?

Mr. **Fomon**. I don't remember.

Mr. **McCollum**. Did you, in the asking of Mr. Moorhead, at any point entertain discussing this with counsel, with your counsel?

Mr. **Fomon**. I told counsel that I was going to do this. But it was not a two-way conversation of my approaching them and saying, "What do you think of my doing this?" I told them I was going to do it.

Mr. **McCollum**. Did they respond in any way? Was it a two-way conversation? Did your counsel react to that?

Mr. **Fomon**. Not that I recall.

Mr. **McCollum**. How close to when you did it did you tell them that?

Mr. **Fomon**. A few days.

Mr. **McCollum**. Before you did it?

Mr. **Fomon**. Before I actually had the lunch, I guess I told them that I was going to do it.

Mr. **McCollum**. Before you asked Mr. Moorhead to do it, did you tell them you were going to do it?

Mr. **Fomon**. No.

Mr. **McCollum**. So the lunch was arranged, actually set, before you advised counsel that you were going to have the lunch?

Mr. **Fomon**. As I recall, yes.

Mr. **McCollum**. Mr. Moorhead, did you set lunches up frequently then with Mrs. Smith when you were in your job at the White House?

Mr. **Moorhead**. I didn't set up lunches frequently. I set up several meetings with Mrs. Smith while I was in the White House.

Mr. **McCollum**. Why did you choose to go through her instead of directly to the Attorney General?

Mr. **Moorhead**. I know her personally. I have great admiration for her, and I knew she would recognize my name when I called her on the telephone.

Mr. **McCollum**. And you didn't think that anybody would perceive that to be a strange or unusual request, since it was a social request; is that right?

Mr. **Moorhead**. No, I did not.

Mr. **McCollum**. You did know that Mr. Fomon intended to discuss the case that was pending, though you didn't say that to Mrs. Smith; is that correct?

Mr. **Moorhead**. Well, I wasn't sure what he was going to discuss. At the time, I didn't know anything about the case, except that there was a case, and that was that.

Mr. **McCollum**. You did say to Mrs. Smith that you anticipated that there would be some business; but, from the way you are describing it, it was a very casual comment. You really used your relationship and the social aspects of the occasion as the pretense for the lunch.

What I am curious about is what you had personally anticipated. You personally anticipated, I gather from what Mr. Fomon had told you, he would be discussing matters concerning this litigation, even though you didn't know anything about it, did you not?

Mr. **Moorhead**. Yes, I anticipated he would discuss the litigation. But, again, it was in the context of a social lunch.

Mr. **McCollum**. Were you afraid that if you had broached the subject of the litigation and spelled it out more to Mrs. Smith that the lunch might not have been arranged that way?

Mr. **Moorhead**. Well, I didn't think about that. I thought about setting up the lunch, and I was told to set up a lunch and tell her it was going to be a social lunch, and that Mr. Fomon had something that he wanted to discuss with the Attorney General. And that is exactly what I did.

Mr. **McCollum**. Did you personally ever have any contact, Mr. Moorhead, by anyone in the Justice Department or anyone in the Reagan administration after this lunch regarding this event?

Mr. **Moorhead**. Yes, I did.

Mr. **McCollum**. Who did you have contact with?

Mr. **Moorhead**. Well, Mr. Trott, after the lunch.

Mr. **McCollum**. He didn't just talk to Mr. Fomon; he talked to you, as well?

Mr. **Moorhead**. I am sorry?

Mr. **McCollum**. He talked to you personally?

Mr. **Moorhead**. He talked to me first, yes.

Mr. **McCollum**. And what did he say to you?

Mr. **Moorhead**. He said that there were channels—did I know that there were channels of communication already established with counsel to handle comments regarding the case, through—I think he said—Mr. Hundley, who I didn't know at the time, and that I should direct all correspondence or all questions to the Justice Department through him. And then he asked for Mr. Fomon's home telephone number.

Mr. **McCollum**. Did you know Mr. Trott before that telephone call?

Mr. **Moorhead**. I had never met him personally. I knew of him.

Mr. **McCollum**. Did you talk with anyone else besides Mr. Trott in the Attorney General's office or in the Reagan administration, after the lunch, about the lunch or about the arrangement for the lunch?

Mr. **Moorhead**. No, I did not.

Mr. **McCollum**. Did you talk to anyone in the Reagan administration or in the Attorney General's office, in specific, at any point after the lunch about the *E.F. Hutton* case?

Mr. **Moorhead**. No, I did not.

Mr. **McCollum**. Mr. Chairman, I think I have probably exhausted my time, and I will let someone else pursue. Thank you.

Mr. **Hughes**. The gentleman from Connecticut is recognized.

Mr. **Morrison**. Thank you, Mr. Chairman.

Mr. Fomon, I am not sure I got it clear. Whose idea was it to go to lunch with the Attorney General?

Mr. **Fomon**. Mine.

Mr. **Morrison**. Did that come to you just yourself? You had no discussions with anyone else before you got this idea?

Mr. **Fomon**. Whomever I have a problem with, I talk to the head person. If I have a problem with General Motors, I call the chairman. If I have a problem with the Justice Department, I call the Attorney General.

Mr. **Morrison**. What event indicated to you that you had the kind of problem that required that you talk to the Attorney General; that it was of that magnitude? What event?

Mr. **Fomon**. Something my lawyers had said to me about, you know, I initially never believed when the investigation started that we were going to be subject to a criminal indictment. I thought at most we were going to incur some kind of injunctive action similar to what the SEC does in the way of censures. And when I realized the seriousness of the charges, I naturally thought that I should do something.

Mr. **Morrison**. What was it? When did this conversation with your lawyers occur?

Mr. **Fomon**. Oh, I don't remember exactly.

Mr. **Morrison**. Give me an approximation.

Mr. **Fomon**. Well, the lunch was mid-November, and it was around that time.

Mr. **Morrison**. And so that was the first time that you felt that there was a risk of criminal prosecution?

Mr. **Fomon**. Yes.

Mr. **Morrison**. And did you at that time ask the lawyers in any way what you could do to do something about the problem?

Mr. **Fomon**. No.

Mr. **Morrison**. You just went off and decided to contact the Attorney General all by yourself?

Mr. **Fomon**. That is what——

Mr. **Morrison**. How did you know what to say to the Attorney General that would be useful?

Mr. **Fomon** [continuing]. Well, I am not stupid. I mean, you know, if I have heard that the grand jury is about to expire—and I assume that if they are going to take any action, they do it prior to the expiration of the grand jury—so I was interested in seeing it extended.

Mr. **Morrison**. Explain to me a little more how you came to know the great significance of the expiring of a grand jury.

Mr. **Fomon**. Well, I consider myself educated.

Mr. **Morrison**. Well, the expiration of the grand jury might be an expiration without consequence. It seems to me you haven't explained to me how it was that you knew what to say to the Attorney General.

Mr. **Fomon**. I don't understand the significance of your question. I was told by my lawyers that the grand jury was going to expire, and they were concerned that they were not going to be able to make submissions to Justice in Washington prior to the expiration of the grand jury. I assumed, naturally, that those submissions had to be made before the expiration.

Mr. **Morrison**. And you didn't say anything to them about contacting the Attorney General; you just contacted the Attorney General, and then you informed them after the lunch was scheduled that you were going to talk to the Attorney General? Is that right?

Mr. **Fomon**. That is right.

Mr. **Morrison**. And they didn't say to you that is a bad idea?

Mr. **Fomon**. I don't remember what they said. But, you know, my lawyers work for me, and they—I don't think they consider it their place to tell me what is bad form and what isn't.

Mr. **Morrison**. Maybe they might advise you on what is more than bad form.

When you had the lunch, you had the discussion and you made your request that the grand jury be extended.

What did the Attorney General say?

Mr. **Fomon**. He didn't really—as I recall, he didn't really say anything. It was a completely noncommittal response. He may have said, "I will look into this situation." He may have said nothing. It was noncommittal.

Mr. **Morrison**. Did he show any visible annoyance at your having raised the issue?

Mr. **Fomon**. No. I think he registered what I considered shock at the fact that E.F. Hutton would be subject to a grand jury investigation which he knew nothing about.

Mr. **Morrison**. And he didn't say anything about this isn't the forum for that kind of a discussion, or "I really can't talk to you about this; you are represented by counsel"? He didn't say any of those things?

Mr. **Fomon**. No, sir.

Mr. **Morrison**. I want to shift gears for 1 minute, if I have 1 minute remaining, Mr. Chairman, and ask a question that is not on this line but really arose in testimony earlier, and that is this: The Justice Department testified today that the reason—one of the major reasons that they didn't indict individuals in this case was that E.F. Hutton's position was such that there would be no deal in terms of a plea bargain of any kind, if individuals were not going to be let off, and that that was what they called the deal breaker. They couldn't make a deal if that was the case.

Is that correct? Was that E.F. Hutton's position?

Mr. **Fomon**. I had nothing to do with that. And I heard that they testified that way this morning. And that is—you know, if it were a deal breaker, it was not at my instruction. It was something planned by the lawyers.

Why would I make that a deal breaker? First of all, I was not a target of the grand jury. When I testified before the grand jury, I was told by Murray, "You should know that you are not a target." When I came out of the testimony, he approached our lawyer, Tom Curnin, and said, "I want to repeat that Mr. Fomon is still not a target of the grand jury."

Mr. **Morrison**. You just said a little earlier that your lawyers worked for you. And are you telling us that your lawyers had the authority to say what was a deal breaker, without your knowledge?

Mr. **Fomon**. Listen, those lawyers, both Murray and our lawyers, said things back and forth all the time that neither one of them believed.

Mr. **Morrison**. So it wasn't a deal breaker. So it wasn't a deal breaker, or it was?

Mr. **Fomon**. No, I don't think it was a deal breaker.

Mr. **Morrison**. But that wasn't Hutton's policy?

Mr. **Fomon**. Look, why would I make something that is a deal breaker? Compared to what we have gone through, why would I want to protect four or five or six individuals, compared to risking the reputation of a firm of 17,000?

Mr. **Morrison**. So, neither you nor the board of Hutton in any way had that condition on your agreeing to the plea?

Mr. **Fomon**. That is correct.

Mr. **Morrison**. I have no further questions, Mr. Chairman.

Mr. **Hughes**. The Chair recognizes the gentleman from California for 5 minutes.

Mr. **Lungren**. Thank you, Mr. Chairman.

Mr. Fomon, so, as I understand it, so far as you know the Attorney General was not notified prior to the time of the luncheon that the subject of E.F. Hutton, or E.F. Hutton's investigation by the Justice Department, was to be brought up; is that correct?

Mr. **Fomon**. That is correct.

Mr. LUNGREN. And, as I understand it, you brought up the subject at the end of the luncheon?

Mr. FOMON. Yes.

Mr. LUNGREN. There was no prelude to it? I mean, it hadn't been discussed even in passing before you brought it up?

Mr. FOMON. No.

Mr. LUNGREN. And I take it from your testimony that the Attorney General, as you said, had a rather noncommittal response. And, as I understand it, he left shortly thereafter; is that correct?

Mr. FOMON. Yes. He had a meeting at the White House. And Mrs. Smith stayed with Jay Moorhead and me, and we finished coffee and concluded the lunch.

Mr. LUNGREN. After the Attorney General left, did you have any further discussion on the subject of the investigation with Mrs. Smith?

Mr. FOMON. No. I wouldn't do that.

Mr. LUNGREN. So, the only time it was discussed was that short period of time in which you basically said what you have testified to here, and you got a noncommittal response from the Attorney General, and he left?

Mr. FOMON. That is correct.

Mr. LUNGREN. Is that the sum and substance of it?

Mr. FOMON. Yes.

Mr. LUNGREN. Did you ever hear back from him at any time in regard to the content of that discussion?

Mr. FOMON. No, I never did.

Mr. LUNGREN. And as far as you recall, there was only one telephone call you personally received from someone from the Justice Department that you believed to be Steve Trott?

Mr. FOMON. Yes.

Mr. LUNGREN. And that one conversation was the one in which he conveyed to you the fact that there was some irritation on the part of the Justice Department with that conversation you had with the Attorney General?

Mr. FOMON. Well, I don't know that it was really irritation. He said that it was not the way to do things.

Mr. LUNGREN. And from now on, to go through the attorneys?

Mr. FOMON. Yes, something like that.

Mr. LUNGREN. And that was the sum and substance of that conversation?

Mr. FOMON. Correct.

Mr. LUNGREN. And you had no further——

Mr. FOMON. I didn't even know who Steve Trott was. I had never heard of him before.

Mr. LUNGREN [continuing]. But you had no further conversations with Mr. Trott after that?

Mr. FOMON. No.

Mr. LUNGREN. Were you ever told by anybody representing the Justice Department that the grand jury had been extended pursuant to your request?

Mr. FOMON. No.

Mr. LUNGREN. Were you ever told that the decision to extend the grand jury was in any way influenced by the discussion you had with William French Smith?

Mr. **Fomon**. No.

Mr. **Lungren**. Were you ever told by your attorneys that, in fact, it was their understanding that the grand jury was extended in part or in whole because of the conversation you had with Mr. Smith?

Mr. **Fomon**. I heard just the contrary recently; that it was extended really in spite of my lunch.

Mr. **Lungren**. Thank you very much.

Mr. **Hughes**. The Chair recognizes the gentleman from Kentucky.

Mr. **Mazzoli**. Thank you very much, Mr. Chairman.

I have to say—and you will excuse me, I guess—but I must remark on what appears to be a total lack of contrition on the basis of what has happened over the last several months. It would appear that you find this whole thing so exasperating and so trying that you can barely show the patience to answer our questions.

Mr. **Fomon**. Well, that is not true. I mean, I don't think contrition is something that you show through great displays of emotion.

Mr. **Mazzoli**. I think—in assuming that my friend from Connecticut, who asked excellent questions, is always very well prepared—that his questions apparently had no particular motive or in-go or something; to me it was certainly not necessary. I was just curious.

You rank yourself in a position where if you want to get something done, you call the top person. You don't waste time with the underlings, the lackeys. You go right to the top. If you have a problem with GM, you call Mr. Smith or the head of GM.

My question is this: When you called Mr. Smith, you called his wife first. Was there some reason you did not call the Attorney General? Why did you use this gentleman who joined you just a day earlier?

Mr. **Fomon**. I don't know.

Mr. **Mazzoli**. There must be some reason for it. I think you do know. This gentleman here has political influence. He came out of the Republican Party. He worked in the Republican White House. The Attorney General——

Mr. **Fomon**. I was not looking for Republican influence.

Mr. **Mazzoli** [continuing]. You didn't call me. I could have called the Attorney General.

Why did you call him?

Mr. **Fomon**. I didn't know you, or maybe I would have.

Mr. **Mazzoli**. You might call me the next time, because we could walk together, and that would be something.

Let me pursue that for a second. I find it remarkable. I am sure that Mr. Moorhead is a man of real talent, and I sincerely say that—a guy that is talented. The question that I would ask is, he was hired one day and put to work immediately and doing the one thing that would be, I would consider, sort of lackey work.

And I would ask Mr. Moorhead, did you feel put upon in, you know, calling to arrange a lunch? I mean, as an administrative assistant, you are paid, I am sure, very well. Do you do that sort of thing every day? Do you call once a day to make Mr. Fomon's luncheon arrangements, or do you call often, or never? What is it? And don't feel offended, because this is what—my friends back home, unsophisticated as they are, would say that this was a fix, an attempted fix that didn't work out. Just that simple. And you were being used as a fixer in an attempt to try to influence in a nonjudicial way——

Mr. **Fomon**. You know, I resent that word "fix."

Mr. **Mazzoli**. Well, then, what would you say, Mr. Fomon, in all respect? What was that thing meant to do? To influence a pending investigation? I don't know what else it could have been.

Mr. **Fomon**. Well, I don't know how extending a grand jury's time can be related to a fix.

Mr. **Mazzoli**. I think my friend from Connecticut's questions illustrated that, to be perfectly honest, you have not the slightest idea what was going on here legally, what all of the intricate movements and scenario being played out were. But you knew that something from above had to trickle down to something below, or this thing was going to get out of your hands.

I mean, is that wrong on my part? Is that illogical on my part?

Mr. **Fomon**. I don't understand your question.

Mr. **Mazzoli**. I think you do. I think that you realize——

Mr. **Fomon**. Don't tell me what I understand, when I say I don't.

Mr. **Mazzoli** [continuing]. Well, you are trying——

Mr. **Fomon**. Please repeat the question.

Mr. **Mazzoli** [continuing]. You are trying to put me in my place, like you put your lawyers in their place, which I think is also kind of interesting. But let me just ask it this way.

You must have known by going to the top that there would be the old trickle-down theory, that influence trickles down. You wouldn't have started at the start with Mr. Murray, because influence doesn't trickle up. You went to the top via Mr. Moorhead and Mrs. Smith in order to have influence brought to bear on a pending investigation. I know of no other conclusion.

Mr. **Fomon**. Well, if I were looking for Mr. Moorhead to help exert influence, why would I go to the Attorney General? I would go to the President of the United States.

Mr. **Mazzoli**. That might be a question that I would ask.

Was that a part of the conversation, Mr. Moorhead? Was that ever brought up?

Mr. **Moorhead**. No, it was not.

Mr. Mazzoli, I would like to just say one thing for the record. It was my decision to set up the lunch through Mrs. Smith, and I have testified to that earlier. Mr. Fomon asked me to set up the lunch with the Attorney General. I know the Attorney General, but I don't know him personally. I do know Mrs. Smith personally. And that is why I set it up through her.

Mr. **Mazzoli**. I am sure you did what you were charged to do in your new employment. I think that you must have felt that part of your responsibilities would be to deal in a nonjudicial legal setting with the legal judicial matter. And I think that this was one way to do it.

Now, it is just that the deal didn't work out, because the Attorney General apparently felt that this was either wrong or it was sensitive or whatever reasons he did not pursue it, as I think the effort had been made to pursue it, or desire to pursue, which was that he should call—just out of curiosity, what would you have liked the Attorney General to do? Extend the grand jury?

Mr. **Fomon**. Mr. Mazzoli, you know, you were out of the room when I explained that the reason for the meeting with the Attorney General was because I was made concerned by our lawyers that we would not get an opportunity to make submissions in Washington. And the sole purpose of the meeting with the Attorney General was to see that we would have an opportunity to make submissions in Washington. I related that to getting the grand jury extended.

Mr. **Mazzoli**. It just appears to me that an effort was made to short-circuit a legal activity well underway, about to reach the denouement, and you wanted to interrupt it.

Mr. **Fomon**. You are wrong. That is not——

Mr. **Mazzoli**. OK. You say what you say.

I would just conclude—because my time has long since expired—by saying that I realize that you did this, in answer to my friend from Connecticut's questions, you did this so low. You didn't check with the lawyers ahead of time because, as you say, they know their place and you know what their place is, and it wasn't to overlook you.

I am just wondering, with Mr. Christopher, do you now, with respect to any of the multitude of investigations that are now going on involving Hutton—as an aftermath of this—I mean, do you have some marching orders on your own part now?

Mr. Moorhead, let me ask you: Would you now, if Mr. Fomon said, "Call Mrs. Meese; I would like to sit down with the Attorney General," would you do it?

Mr. **Moorhead**. No, I would not.

Mr. **Mazzoli**. Why not, if you did it so willingly the time before?

Mr. **Moorhead**. Let me rephrase that. I would recommend strongly against it.

Mr. **Hughes**. The gentleman's time has expired.

As I understand it, Mr. Fomon, it became evident to you from discussions with your attorney that indictments were imminent. Your attorneys were having difficulty making submissions to the Justice Department, providing mitigating evidence and circumstances. Out of frustration, they told you at some point that they were having difficulty dealing with Scranton and the Department of Justice.

It was at that time that you decided, from your testimony, on your own, even though you alerted your attorneys to what you were going to do, to ask Jay Moorhead, who was on the job the first day, to make a call and set up an appointment with the Attorney General.

Mr. **Fomon**. I think that is correct, except I think I went ahead and did it and then told the lawyers.

Mr. **Hughes**. I see. It was the other way around.

Do you know what was needed at that time was an extension of the grand jury, in particular, that the grand jury's term had expired, and you would not have an ample opportunity to make the submission and provide mitigating evidence?

Mr. **Fomon**. Correct.

Mr. **Hughes**. So your motive was to ask the Attorney General to intercede and to extend the grand jury to permit——

Mr. **Fomon**. That was the sole reason.

Mr. **Hughes** [continuing]. To permit the submission of evidence, and that is the reason.

Mr. **Fomon**. Correct.

Mr. **Hughes**. I understand.

Mr. Moorhead, this was your first duty, was it, on the job?

Mr. **Moorhead**. I am sorry, first duty—I don't recall if it was my first duty. I think it had been my first day or two. I was running around signing personnel forms——

Mr. **Hughes**. Aside from the ministerial things you have to do to give the number of deductions for your family on the W-2 and all those things, aside from those things which every new employee has to go through, was this your first duty?

Mr. **Moorhead** [continuing]. It was one of my first duties, yes.

Mr. **Hughes**. And do you recall how many days before November 15—can you be as precise as you can—that you made the call to Mrs. Smith?

Mr. **Moorhead**. Three or four days before. Not more than a week before.

Mr. **Hughes**. So it could have been as much as a week, but not less than 3 or 4 days before?

Mr. **Moorhead**. That is correct.

Mr. **Hughes**. And Mrs. Smith was the one that got back to you with the date?

Mr. **Moorhead**. That is correct.

Mr. **Hughes**. As I understand it, the Attorney General's response was uncertain to you when you made the approach. I gather this was at the end of the social luncheon, you chatted about a number of other things, and at the end of the luncheon was when you broached the subject of the business.

Mr. **Fomon**. Correct.

Mr. **Hughes**. Your concerns with E.F. Hutton. Was the Attorney General familiar with the E.F. Hutton investigation?

Mr. **Fomon**. No, he was not.

Mr. **Hughes**. What made you believe that? What makes you believe that?

Mr. **Fomon**. Because there was a sense of shock registered on his face when I told him.

Mr. **Hughes**. So from that, you gathered he did not know. Did he say he did not know?

Mr. **Fomon**. I don't recall exactly whether he said he didn't know. It was quite apparent he did not know.

Would you agree with that?

Mr. **Moorhead**. Yes, I would. It was clear to me he did not know anything about the investigation.

Mr. **Hughes**. Was it your recollection—Mr. Fomon has testified, in response to a question, that he did not seem agitated. Was that your impression also?

Mr. **Moorhead**. My impression was he was very anxious to leave, and in fact was leaving at the very end of the luncheon.

Mr. **Hughes**. He had another meeting, did he not?

Mr. **Moorhead**. Yes.

Mr. Hughes. And Mrs. Smith was left behind.

Mr. Moorhead. Yes, that is correct.

Mr. Hughes. Now, subsequent to that meeting, did you place a call to anyone at the Justice Department as a followup?

Mr. Moorhead. Yes.

Mr. Hughes. When was that, and to whom?

Mr. Moorhead. That was to Mr. Trott, about 5 or 6 days after the luncheon or the following week before Thanksgiving sometime.

Mr. Hughes. And that is because you had not heard back from the Justice Department at that time?

Mr. Moorhead. Yes.

Mr. Hughes. Did you try to reach the Attorney General?

Mr. Moorhead. No.

Mr. Hughes. So Mr. Trott was the only one that you called?

Mr. Moorhead. That I recall, yes.

Mr. Hughes. Did you try to reach anyone else at Justice?

Mr. Moorhead. No.

Mr. Hughes. What did you say to Mr. Trott, and what did he say to you?

Mr. Moorhead. I said initially, "Mr. Trott, do you know that there is a grand jury investigation of E.F. Hutton underway and that the company is trying to make some submissions prior to the conclusion of the grand jury, do you know if the company is going to be allowed to do that or not?"

As I recall, he was unfamiliar with what I was talking about.

Mr. Hughes. He didn't know what you were talking about?

Mr. Moorhead. Initially, that was my impression. He said, "I will have to get back to you." And then——

Mr. Hughes. Did he say to you "That is not the proper thing to do"?

Mr. Moorhead [continuing]. He did, when he called back the next time, yes.

Mr. Hughes. I am talking about this conversation. At this time, when you called him to relate that you had had a meeting with Mr. Fomon, chairman of the board of E.F. Hutton, and the Attorney General and Mrs. Smith and at the meeting a request was made of an extension of the grand jury or concerns over not being able to make submissions. I presume you went over this, because he did not know what it was all about when you called him.

Mr. Moorhead. Right. I don't recall him saying that specifically, no.

Mr. Hughes. Did you tell Mr. Trott what was requested at the meeting?

Mr. Moorhead. Again, I think that I did in that conversation explain to him, as I testified before, that the company was trying to make some written submissions to the Department of Justice prior to the conclusion of the grand jury. That was the extent of what I told him.

Mr. Hughes. And did he at that time tell you that that wasn't proper, that you should not be proceeding in this fashion with the Attorney General or Mr. Trott?

Mr. Moorhead. Again, Mr. Chairman, in that conversation I don't recall him doing that. I definitely recall him doing that either later that day or the next day.

Mr. **Hughes**. So he called you back. It was at that time that you had another conversation with Mr. Trott.

Mr. **Moorhead**. Yes.

Mr. **Hughes**. What did he say during that conversation?

Mr. **Moorhead**. As I recall, that he thought this was being handled through normal channels and that it should—all communications between Hutton and the Justice Department should be between our attorneys and our counsel. He mentioned we had a counsel, an attorney in Washington, who was dealing directly with the Justice Department on these matters and that we shouldn't have any more contacts with the Justice Department except through the attorneys.

Mr. **Hughes**. Did he tell you that the term of the grand jury had been extended on the 16th?

Mr. **Moorhead**. No, he did not.

Mr. **Hughes**. The fact of the matter is you did not know at that time the grand jury had been extended?

Mr. **Moorhead**. No, we did not know.

Mr. **Hughes**. It is obvious you did not know on the 15th that the intent was to—from the testimony—to extend the grand jury.

Mr. **Moorhead**. No.

Mr. **Fomon**. You know, had I to do it all over again, I would not have set up the meeting with Smith, but then, as I have said before, I did not know the protocol of being indicted. I didn't know there was a ritual to it. Now I know there is. But then I would have done a lot of things differently.

For example, I never would have entered into the guilty plea. I never would have permitted the board of directors to enter into that guilty plea. I would have insisted that the lawyers explain in greater depth the consequences of doing something like that.

Mr. **Hughes**. It is also obvious that, from your response, you felt very strongly about not protecting any individuals that might have been culpable.

Mr. **Fomon**. I would not protect any individuals at the expense of a national firm with an 80-year reputation.

Mr. **Hughes**. In response to my colleague from Connecticut's questioning, you made it rather clear that you feel that way about it, and yet obviously from the testimony, if it is believable, and I believe it is, the representations were made by some of your corporate counsel that individual culpability wasn't on the table, that that was a deal buster.

Mr. **Fomon**. They did not get those instructions from me.

Mr. **Hughes**. Were you aware of the fact that the corporate counsel was apparently negotiating also for individual defendants?

Mr. **Fomon**. I knew that Murray was threatening individual indictments. I did not know whom he was threatening. I would not consider that a deal buster.

Mr. **Hughes**. Is it fair for us to say that you asked Mr. Moorhead to make that call because you knew he had connections in Washington?

Mr. **Fomon**. Absolutely not.

Mr. **Hughes**. That was not the reason?

Mr. **Fomon**. I didn't know that he knew Mrs. Smith.

Mr. **Hughes**. You knew he worked at the White House.

Mr. **Fomon**. Yes, but that is kind of a "so-what." There are hundreds and thousands of people who work there.

Mr. **Hughes**. But he was very well placed at the White House, though, Mr. Fomon.

Mr. **Fomon**. Well, you know, had I wanted to really use his placement, as I said, I certainly would have had him call Mr. Reagan. Why screw around with William French Smith?

Mr. **Hughes**. Does the gentleman from Florida have any response to that?

Mr. **McCollum**. I have no response. I would like to ask some more questions.

Mr. **Hughes**. The gentleman from Florida is recognized.

Mr. **McCollum**. I want to break the tenor of this a little bit and say there are some nice things to be said in this area. I think Mr. Moorhead is to be complimented for what I understand is considerable cooperation in early stages in trying to assist the committee in all its paperwork problems. I want to compliment him for that.

Mr. Moorhead, I want to ask you about the conversation with Mr. Trott you just discussed with the chairman just for a second. You told me in the initial questioning period that you did not know Mr. Trott personally, you had not met him prior to this, though you knew of him and so forth. What prompted you to call Mr. Trott after the lunch 5 days or so later?

Mr. **Moorhead**. I knew he was head of the Criminal Division.

Mr. **McCollum**. You picked him out because he was the head of the Criminal Division and called him?

Mr. **Moorhead**. Yes.

Mr. **McCollum**. You did not choose to go to any other direction, you just thought that was the best thing to do, is to find out how the case was going?

Mr. **Moorhead**. I understood that was the chain of command up to Mr. Trott.

Mr. **McCollum**. I can understand why Mr. Fomon might have asked you to have the lunch, I wouldn't agree with the propriety of it, and I am sure, as he said, he would not do it again if he had another occasion, and there are a lot of questions to ask about it in retrospect, but that is hindsight, and so forth.

I don't understand why at the second stage, 5 days after the lunch, with no real response from Mr. Smith apparent, you chose to go, or Mr. Fomon chose to have you go directly to make an inquiry to Mr. Trott instead of going back down to your lawyers and saying, "Hey, we had this lunch, what is the deal, don't you think somebody ought to call Trott?"

So I would like to ask you to spell that out for me, what went into that? Did you have a discussion with Mr. Fomon? Did you have a discussion with any of the attorneys, counsel, active in the suit or counsel for the corporation?

Mr. **Moorhead**. I didn't have a discussion with Mr. Fomon, I don't recall. I think I did discuss it with Mr. Rae, our general counsel, and maybe Mr. Curnin, too; I can't recall.

Mr. **McCollum**. That is a strange thing to me, you went to make that call to Mr. Trott—and it might be maybe stranger for Mr. Fomon to want the lunch I guess at that point, for you to intercede to ask the legal questions straight up rather than going through the corporation's lawyers. Did Mr. Fomon ask you to make that direct intercession at this point, the second stage, the call to Mr. Trott?

Mr. **Moorhead**. I don't think he asked me to call Mr. Trott, as I recall. It was 5 or 6 days after the lunch, and we hadn't heard anything. My understanding was that we—the grand jury was about to expire, and we wanted to find out what was happening. Our lawyers didn't know what was happening.

Mr. **McCollum**. Mr. Fomon, any time since this affair, this lunch I should say, have you had any direct contact with William French Smith?

Mr. **Fomon**. No, I have not.

Mr. **McCollum**. No telephone conversations, no luncheons, no nothing?

Mr. **Fomon**. No. You know, Mr. McCollum, I want to point out that I used Jay Moorhead for setting up lunches all the time. Daily he arranges lunches. In fact, I guess what is interesting here is that it was one of his first days on the job. And the fact that he had worked in the White House—but he does this every day.

Mr. **McCollum**. I just want to comment that since the impropriety and hindsight that you say you also now sense in the occasion, I have not found from listening to all of the discussions that have come before this committee over the many months that anything actually came out of this that in any way affected the outcome of the decisionmaking process of the Department of Justice. I don't see that in the bottom line anything like that occurred, but I think it is our duty to explore, and that is what we have been doing here with you today as we have in the past, to make sure that nothing did or nothing improper occurred. Nothing has happened today in your testimony that will lead me to any other conclusion.

But I will say this, that from the entire hearings we have held with regard to E.F. Hutton, I have had two striking conclusions. One of them I made the day Mr. Rae was in here. I felt he had given some pretty bum advice along the way in the *E.F. Hutton* case and made some slipshod decisions, and I told him so.

The other thing I haven't said, but I feel very strongly about, listening to you today in regard to this, is in the area of legal counsel. I don't think, for whatever reason, either your lack of relations or their fault in not coming to you, that your counsel had the kind of direct involvement, whether it is Mr. Rae or the attorneys more directly involved with the litigation, had the direct involvement with you at this stage, at the point where you went to Mr. Smith and the few days after that when this whole question of the indictment came home to you. They apparently didn't get across some of this to you that they should have. And I don't know who to lay the blame on. I am just saying you didn't get it.

Mr. **Fomon**. As you have observed, I finally got smart and hired new counsel.

Mr. **McCollum**. OK. Fair enough. I don't have any more observations to make, and I don't have any more questions to make except to say thank you, and I will yield back to the chairman.

Mr. **Hughes**. Mr. Mazzoli.

Mr. **Mazzoli**. Thank you, Mr. Chairman.

I have no questions, because I have reached the same conclusion that my friend from Florida has, which is, all these days of hearings have elicited no evidence that any influence was brought to bear upon the Justice Department, from outside or inside, upon Mr. Murray and the people in Pennsylvania in the conduct of their case. And I think that was the searching point, we had to find some evidence not that they made wrong judgments, not that they should have indicted you and didn't, not that they should have indicted those people in the middle district and didn't, but whether or not they were influenced in their judgment by political matters, by influence from their superiors, whatever, and I have not found that.

But I tell you what I have found, and I would like to share this with you just a little bit because I am sure from your vantage point on Wall Street, with the heavy hitters, it probably seldom comes to your attention in any direct way because you are pretty much insulated from things, as we are. Members of Congress are always felt to be insulated and isolated from the realities of the world, but clearly you are, because if you think—and I say this in all respect—that there is a protocol about an indictment which suggests that you somehow have to be indoctrinated into indictments and go to law school to realize it is improper to call the Attorney General to try to manipulate a pending investigation, then I am driven to the conclusion that the ethics on Wall Street, the ethics in the boardroom are abysmally out of character and out of kilter.

Now, I say that because if there is any one thing that people in leadership positions have to do is remember the example that they set for the world, for the people, and I have to say candidly the example of using a young man just freshly one day on the job but from the White House, with obvious political connections, to use him to do what is obviously an effort to intrude upon, interrupt, change, manipulate a pending legal case doesn't take going to law school, doesn't take to studying the ethicists of the world to understand.

That was clearly an effort to influence something which was not to be influenced at that point. So the only thing I can say, maybe emerging from all these dark thunderclouds which have clapped over E.F. Hutton and over you personally, maybe emerging from it might be a little better understanding on Wall Street among the CEO's that there is such a thing as an ethic, there is such a thing as fair treatment, there is such a thing as remembering the amenities and the niceties and legalities of things, and that simply because you can whistle and things are done, you can click your hand and things get done and people know their place and you have insisted people around you know their place, that doesn't always translate into correct actions.

So I just would say, maybe our friend, the Chairman of the committee, in this long series of hearings has probably shown a light on the underbelly of American businesses, which very much needs an airing and a lighting. And maybe from it will come some good.

I thank the chairman.

Mr. HUGHES. I thank the gentleman from Kentucky.

I don't have any further questions. I think you have responded to all the questions I have, and obviously the members have. I want to thank you, Mr. Fomon, Mr. Moorhead, because you were forthcoming. In the interviews you were very candid with the staff and very cooperative, and I appreciate that. I find your testimony to be quite credible.

I differ with my colleague from Kentucky a little bit on some things. I sense in the attorney's correspondence some frustration. Of course, attorneys play hardball just like Justice does, and they say a lot of things, as you indicated, that they don't mean as they develop their strategy, and they endeavor to advance their position to try to resolve the matter, and there was some frustration. They were getting nowhere in Scranton with the U.S. attorney. He wasn't prepared to talk with them. I understand that.

I understand the grand jury was expiring and what that meant, and I understand that the attorney could have picked up the telephone and called Mr. Trott and complained and could have called the Attorney General and complained. That is perfectly within the right of any citizen, to complain to the Attorney General. If they don't like the way Mr. Murray is handling a case, or Mr. Clark is handling a case, they have that right.

But, really, what I think is distressing is all the coincidences, and I really haven't decided how I come down on just what we have found, because there are some discrepancies, some minor discrepancies, in some instances major discrepancies. The fact of the matter is I believe Mr. Moorhead was selected, because he did have White House connections, to make that telephone call. Maybe not. But certainly that is the perception that anyone would have that would look at that, could infer from that. And it may be that there was some basic unfairness in not permitting the attorneys to make submissions, and maybe the message wasn't getting through to the folks at Justice.

But it seems to me that the method selected probably was not the best, and I think, as you have indicated, you acknowledged you wouldn't do that again, and I think that in itself is very positive. I think out of the hearings have come a lot of very positive things. We don't have all the documents yet, but it is our intent to get all the documents so we can complete our investigation.

I don't know how we could have made a determination as to whether or not there was undue influence, improper influence. I mean, there are all kinds of influences that affect indictments or information and trials, and some are positive influences and some are not so positive. The basic question was whether or not there were improper influences.

The second question was whether or not this represents a pattern of something that is broader than just the E.F. Hutton issue, and the third question that we are going to have to address is whether the law is adequate, if in fact we need additional laws to deal with this type of a situation.

It is distressing to me that no individuals were charged or prosecuted. That was a prosecutor's call, and there were reasons, and they have cited them, for not moving against individuals. One of the reasons why there was such a hue and cry throughout the country is because all of the evidence suggested that E.F. Hutton made tens of millions of dollars and yet were fined $2 million. That is hard to explain to somebody who is arrested for a small offense and goes to jail.

It looks like we have a dual standard, one for the corporate world, one for the well connected, and one for little people, and our criminal justice system relies upon equity and justice for all people. Out of the hearing, hopefully, will come some positive things.

We have blind spots in the statute, we were told today perhaps the penal sanctions, the fines were not adequate. If things like that come out of it, they are very worthwhile. Certainly what has come out of it also is some insight into the nature of the scheme, and I am not sure that we or the general population understood what was involved because certainly the media coverage after the plea was very confusing and inadequate, to say the least.

So I want to thank you. I want to thank you, Mr. Christopher, for picking up the reins and doing an excellent job. We still have some differences over some documents that we are still discussing that we would like to resolve, but E.F. Hutton has been much more forthcoming since you have come on board, Mr. Christopher, and we appreciate that.

Mr. Fomon, I mean it when I say we appreciate your candor and willingness to come here today on such short notice to complete your part of the testimony.

Mr. FOMON. Thank you.

Mr. HUGHES. Thank you very much.

The subcommittee stands adjourned.

[Whereupon, at 6:10 p.m., the subcommittee was adjourned subject to the call of the Chair.]

ADDITIONAL MATERIAL

Benjamin J. Guthrie
Clerk

W. Raymond Colley
Deputy Clerk

Office of the Clerk
U.S. House of Representatives
Washington, DC 20515

May 13, 1986

MEMORANDUM

TO: The Honorable William J. Hughes
Chairman
Subcommittee on Crime
Committee on the Judiciary

FROM: Steven R. Ross SRR
General Counsel to the Clerk

Charles Tiefer CT
Deputy General Counsel to the Clerk

SUBJECT: Potential Contempts by Hutton in Refusing to Produce Subpoenaed Documents

E.F. Hutton has objected to producing various subpoenaed documents required by your Subcommittee's investigation. At your request, we have reviewed the correspondence between the Subcommittee and Hutton regarding Hutton's asserted claims for withholding these documents, and the applicable law, and with regard to the particular documents discussed below, Hutton's claims are without merit. As Chairman, you may overrule its claims on the basis of this memorandum, and fix a final date for production. Were there to be a further refusal to produce the documents by that date, the subpoena respondent at Hutton would be in contempt of Congress, and would be subject to prosecution pursuant to 2 U.S.C. § 192. The Subcommittee is not obliged to [illegible] United States District Court for the Middle District of Pennsylvania has [illegible] the legal foundation of the Subcommittee's investigation. *In the Matter of: Harrisburg Grand Jury - 83-2*, Misc. No. 83-142 (M.D. Pa. April 1, 1986).

I. Hutton's Obligation to Provide the Correspondence Regarding Immunity of Hutton Officers From Prosecution

Among other aspects of its investigation, the Subcommittee has examined how no Hutton officers were individually prosecuted for the crimes for which Hutton as a corporate entity pled guilty to 2,000 felony counts. The Subcommittee investigation has focused on such matters as the sequence by which various Hutton officials obtained promises of non-prosecution from the Department of Justice. Those promises were set forth in correspondence from the Department. The Subcommittee's subpoena to Hutton requires production of that correspondence, and the Subcommittee has insisted on production, but Hutton has continued to withhold key parts of the correspondence.

Hutton admits, by letter from its counsel dated March 31, 1986, it "masked the names of individuals" as well as "information from which particular individuals could be readily identified" when producing incomplete copies of the correspondence. Our examination of the correspondence, and particularly of the letters granting Hutton officers immunity from prosecution, confirms that this "masking" rendered the copies unintelligible and virtually useless. Hutton's claim for refusing to provide intact copies of the correspondence may be overruled, requiring production on penalty of citation and prosecution pursuant to 2 U.S.C. § 192, unless Hutton has a privilege regarding the material withheld.

Hutton's claim for withholding has as its central thrust a broad challenge to the Subcommittee's investigative authority, in which Hutton implies that use of such authority to investigate it is "totalitarian":

> Both in general and in the specific circumstances present here, these rules [relied upon by Hutton for refusing to provide the subpoenaed information] are consistent with that respect for privacy and personal rights which distinguishes us from totalitarian regimes, and with simple fairness: an individual whom the prosecuting authorities ultimately charge with no wrongdoing ought not to be subject to public obloquy merely because at some point two litigating lawyers [i.e., Hutton's and the Justice Department's], with the puffery and bluff typical of hard negotiations, discuss whether there is credible evidence of any offense.1/

Hutton's rhetorical arguments would deny the Subcommittee key correspondence discussing whether "there [wa]s credible evidence of any offense" -- and more importantly, how and when the

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1/ All quotations from Hutton are from its counsel's letter.

Department forfeited its power to prosecute individuals for such offenses. Hutton contends that the Subcommittee is barred from investigating why "the prosecuting authorities ultimately charge[d]" the top officials at Hutton "with no wrong," because such investigation would "subject to public obloquy" the Hutton officers.

Hutton's argument is utterly without merit. Congress's investigation of Watergate and its many contemporary investigations of the Department of Justice, confirms history's lesson, that Congress regularly investigates whether individuals were not charged with offenses because of a gap in the laws or in the administration of the laws, even when the individuals who escaped prosecution may face some "public obloquy" from the investigation. The Supreme Court expressly sanctions precisely such investigations, because if the Congress does not investigate why the Justice Department fails to indict individuals engaged in massive offenses, no other body has the constitutional responsibility and authority to do so.

As the Supreme Court explained, in upholding Congress's investigation of the Teapot Dome scandal -- an investigation, like the Hutton investigation, precisely about the behavior of corporate officers and the reason why the Justice Department had not indicted them:

> [T]he subject to be investigated was the administration of the Department of Justice . . . particularly whether the Attorney General and his assistants were performing or neglecting their duties in respect of the institution and prosecution of proceedings to punish crimes . . . --specific instances of alleged neglect being recited . . . .
>
> We conclude that the investigation was ordered for a legitimate object . . . .

McGrain v. Daugherty, 273 U.S. 135, 176, 180 (1927)(emphasis supplied). McGrain firmly establishes that Hutton cannot legitimately withhold documents on a generalized claim that Congress should not investigate how its top officers avoided indictment.

Hutton wraps its generalized argument around a vague claim regarding the grand jury secrecy rules:

> We have also masked the names of individuals and, in a very few situations, information from which particular individuals could be readily identified. We have done so because we believe that Hutton is not legally at liberty to do otherwise, that these individuals are entitled to the protection of the rules of grand jury secrecy, and that Hutton has no power unilaterally to waive their rights. Discussions between Hutton's counsel and Mr. Murray concerning these individuals occurred only to the extent that the individuals were the subject of testimony before the grand jury. We believe it is settled that grand jury proceedings should be totally secret and that the affected individuals have, unless they personally waive it, a privilege to insure that grand jury evidence concerning them is not disseminated publicly.

Despite a year to marshal its basis for withholding evidence from the Subcommittee, Hutton presents a claim utterly without any support. Hutton does not cite the language of the procedural rule in question to support its withholding. Moreover, Hutton pointedly fails to cite the language of a single judicial decision about the grand jury rule. Although Hutton has been represented by a host of lawyers, it fails to produce a single authority to support the claim, a failure which speaks eloquently of its lack of basis.

It is evident why Hutton avoids citing the language of the rule. The rule concerning grand jury secrecy, Federal Rule of Criminal Procedure 6(e), is very familiar to this Subcommittee. See In the Matter of: Harrisburg Grand Jury - 83-2, supra. Rule 6(e) bars some inquiries to grand jurors, but contrary to Hutton's assertion, it does not bar evidentiary demands to grand jury witnesses, such as Hutton's officers, much less provide a privilege which Hutton can assert for withholding the subpoenaed correspondence. Rule 6(e)'s coverage of grand jurors, and its exclusion of witnesses, is plain from its language:

> [A] juror, attorney, interpreter, stenographer, operator of a recording device, or any typist who transcribes recorded testimony may disclose matters occurring before the grand jury only when so directed by the court 2/

2/ Perhaps a different question, as well as a further line of Subcommittee inquiry, would be presented if Hutton claimed that any "juror, attorney, interpreter, stenographer, operator of a (footnote continued)

Moreover, Rule 6(e) explicitly excludes coverage of any individuals not included:

> No obligation of secrecy may be imposed upon any person except in accordance with this rule.

It is quite evident that Rule 6(e) covers those present in the grand jury room _except_ witnesses. If the plain language of the rule were not sufficiently clear, the Supreme Court has recently underscored the point. In _United States v. Sells Engineering, Inc_, 463 U.S. 418 (1983), the Court stated regarding the secrecy rule of Rule 6(e): "Witnesses are _not_ under the prohibition," _id._ at 425 (emphasis supplied), unless they are in "one of the enumerated categories" (such as jurors or interpreters). Of course, this has been the interpretation of the plain language of the rule by the lower courts as well.[3]

It is hornbook law that in many contexts, evidence can be obtained from private parties, like Hutton and its officers, who are not covered by a secrecy rule, even when government personnel are covered by a secrecy rule.[4] For example, copies of Hutton's

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recording device, or any typist" servicing the Harrisburg Grand Jury were employees or agents of the company.

[3] _See, e.g._, _In re Investigation Before the April 1975 Grand Jury_, 531 F.2d 600, 607 n.11 (D.C. Cir. 1976); _In re Vescovo Special Grand Jury_, 473 F. Supp. 1335 (C.D. Cal. 1979).

[4] The question of whether this correspondence would be covered by Rule 6(e) if sought from the Justice Department need not be addressed here, since the subpoena at issue here sought the (footnote continued)

tax returns, or those of its officers, could be subpoenaed from Hutton or its officers, although a secrecy rule prevents obtaining them from the Treasury Department. In *United States v. O'Mara*, 122 F. Supp. 399 (D.D.C. 1954), a Congressional committee subpoenaed an income tax return from a witness. The witness, like Hutton, attempted to withhold it, on the ground of the secrecy rule covering the Treasury Department. The committee held him in contempt and he was prosecuted and convicted of contempt of Congress, and the court sustained the contempt conviction. As it noted, "The statutory privilege is limited to the prohibition of disclosures by officers of the government. . . . [T]he Court feels that the defendant ran the risk that might have been involved in refusing to comply with the subpoena, and the Court has no alternative except to find the defendant guilty." *Id.* at 400 (quoting another case).

The Supreme Court has left no doubt that such rules which do not cover private parties, provide them with no privilege against subpoenas. It cited *O'Mara* with approval in *St. Regis Paper Co. v. United States*, 368 U.S. 208, 219 n.10 (1961), in which the Court concluded:

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correspondence from Hutton, not from the Justice Department. The discussion here indulges an assumption Hutton wishes to make to show that Hutton cannot withhold the evidence under any construction of the rule.

> [A]lthough tax returns, like these census reports, are made confidential within the government bureaus, copies in the hands of the taxpayer are held subject to discovery.

Id., 368 U.S. at 218-19.

In sum, Hutton's reliance on the grand jury secrecy rule is without merit. The rule expressly and deliberately does not cover witnesses, it expressly states that coverage is limited to the persons stated, and it has been thus read by the Supreme Court. O'Mara shows that when the language of a secrecy rule covers a government agency, but not private parties, then Congress can obtain the subpoenaed records from those private parties on pain of citation and conviction for contempt of Congress, and the Supreme Court's citation of O'Mara with approval provides a high level of confidence for the prosecution and conviction of individuals withholding evidence from a Congressional investigation. Accordingly, Hutton's objection may be overruled and a final date for production of the correspondence may be fixed on pain of contempt of Congress.

II. Hutton Cannot Withhold Audit Records, Correspondence with the Justice Department, and Other Documents on Claim of Attorney-Client Privilege

Hutton has claimed attorney-client privilege for a number of documents for which that claim may be overruled and production of the documents may be required.[5]

First, Hutton has claimed privilege for its internal audit reports and work papers for 1979-85, items 67 and 68 in the document log used in the correspondence between Hutton and the Subcommittee. Hutton describes its audit reports as "Audit reports on branches or offices and headquarters operating units prepared under the supervision of and at the direction of counsel to insure compliance with regulatory and internal policy guidelines." Notwithstanding Hutton's flowery contentions about the "supervision" and "direction of counsel," Hutton has presented no particularized claim that individual papers in this

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5/ The documents discussed here are ones on which a claim of attorney-client privilege would not be sustained even in a court which deemed itself bound by the privilege, and we presented the analysis from the perspective of such a court. The discussion here also encompasses the work-product privilege to the extent it is deemed a basis for withholding from Congress, which is minimal.

It may be noted that the historical position of the Congress, starting with Parliament's power and continuing through the nineteenth and twentieth centuries to investigations of the House Energy and Commerce and House Foreign Affairs Committees earlier this year, has consistently been that Congressional committees are not bound by attorney-client privilege, particularly since there is no statute or rule prescribing that privilege for Congressional investigations; accordingly, Congressional investigations can accept or reject claims of attorney-client privilege as a matter of discretion. See Proceedings Against Ralph Bernstein and Joseph Bernstein, H.R. Rep. No. 462, 99th Cong., 2d Sess. 12-14 (1986)(discussing the history). However, for purposes of the discussion here, the attorney-client privilege is being addressed from the perspective of a court bound by the privilege. This discussion may inform the Subcommittee in the exercise of its discretion.

[illegible] prepared to assist particular counsel in specific [illegible]ers. Rather, Hutton seeks a blanket privilege for six [illegible] company audits and auditing work papers, which this Congressional investigation obviously needs as it probes Hutton's top officers' claims that they knew so little about what was going on (but were not deficient in supposedly knowing so little) of the company's conduct underlying the 2,000 felony counts.

The Supreme Court has in two recent lengthy discussions confirmed that there is no such privilege for auditing work. United States v. Arthur Young & Co., 465 U.S. 805 (1984); Couch v. United States, 409 U.S. 322 (1973). These cases authoritatively resolve the point against Hutton, and render meritless an attempt to withhold such auditing records from the Congress. Hutton makes general claims about how its auditors were working "to insure compliance with regulatory and internal policy guidelines," but so were the auditors denied a privilege in Arthur Young.[6] Any other conclusion would invite companies to evade the *Arthur Young* ruling by use of flowery verbal formula not affecting the underlying audit work. That has never been and is not now the law. The burden is on those who would claim attorney-client privilege, and Hutton's claims of privilege for its internal audits have not met that burden. *Barclaysamerican Corp. v. Kane*, 746 F.2d 653, 658 (10th Cir. 1984). Accordingly, the claim of privilege regarding the audits may be overruled.

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[6] In fact, such work would not be privileged even if those conducting it were lawyers themselves, let alone Hutton's auditors. For example, in In re Fisher, 51 F.2d 424 (S.D.N.Y 1931), an attorney who also served his client, Mr. Fisher, as accountant initially refused "to produce in evidence monthly account sheets made by accountants in his employ in [the] course of auditing [Fisher's] books." Id. at 425. The court sternly reminded that "[t]here is no privilege with regard to communications made to accountants," and admonished that "the witness should be directed to testify with regard to [Fisher's] books and to produce in evidence the monthly work sheets made by (footnote continued)

Second, Hutton has sought to claim privilege for various information that came to it from the outside. These include items 62 and 63, which are reports of conversations with Assistant United States Attorney Al Murray; item 78, a memorandum of interview reporting conversations with officers of the Bank of America; items 103 and 126, which are reports of conversations with U.S. Trust Company; and the parts of item 48 reporting conversations with Genessee Bank, Chemical Bank, and U.S. Trust Company. Hutton has thrown out various makeweight excuses for withholding these documents. The short answer is that the descriptions of the outside contacts must be provided. The Subcommittee has a very strong interest in learning the content of these specific contacts, which is an ample showing of good cause. Despite repeated opportunities, Hutton has made no detailed showing to justify withholding that information.

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the accountants." *Id.*

As one court noted:

> Of particular importance in this case is the settled rule that the shield of confidentiality does not extend to reports or comments on information coming from persons outside the institutional client . . . . Statements of [outside] witnesses secured in anticipation of litigation, or summaries of conferences held with such persons are not subject to the attorney-client privilege.

Jupiter Painting Contracting Co., Inc. v. United States, 87 F.R.D. 593, 598 (E.D. Pa. 1980).[7]

CONCLUSION

Hutton has had full opportunities to attempt to justify its withholding of the documents discussed above. It has presented no authority justifying that withholding, and the clear mandates of the Supreme Court show that it must produce the documents. Its objections may be overruled and it may be instructed, on penalty of contempt, to provide the documents.

7/ We know of no instance in which any Congressional Investigations have accepted a plea of "work product" as an excuse for withholding needed information, but even if they did, such a plea is overcome when there is "good cause." The Subcommittee's previous experience with questioning the individuals involved shows that that, to be charitable, they have memory problems necessitating resort to contemporaneous documents. Of course, the contacts in question are part of the central puzzle of Hutton's conduct leading up to the failure to indict its officers.

NINETY-NINTH CONGRESS

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GENERAL COUNSEL
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ASSOCIATE COUNSEL
ALAN F. COFFEY, JR.

May 20, 1986

Mr. Robert Rittereiser:
President
E.F. Hutton & Co., Inc.
1 Battery Park Plaza
12th Floor
New York, New York 10004

Dear Mr. Rittereiser:

Attached is a copy of a subpoena served on Scott Pierce as President of E.F. Hutton & Company. As you are his successor, I am substituting you as respondent on the subpoena. I am directing this letter to you because, as respondent, you will be personally responsible for any failure to comply with the subpoena.

E.F. Hutton has claimed in its September 4, 1985 privilege log that certain documents subpoenaed by the Subcommittee on Crime are protected under the attorney-client privilege, the joint defense privilege, the work product doctrine, and rules relating to grand jury secrecy. Pursuant to my authority as Chairman of the Subcommittee, I have decided to accommodate certain of the Company's claims in this instance and you need not produce any of the numerous documents listed in the privilege log other than those for which your claim of privilege is specifically rejected below. I have attached a copy of a memorandum from the General Counsel to the Clerk of the House so advising me.

Hutton's claims of privilege are denied with respect to documents identified by the following numbers in the privilege log dated September 4, 1985:

48 (insofar as it relates to conversations with Genesee Bank, Chemical Bank, and U.S. Trust Company), 62, 63, 67, 68, 78, 103, and 126.

In addition, the Company's claims of grand jury secrecy protection are denied with respect to all immunity letters and all redacted documents. All documents that the Company has redacted on grounds of grand jury secrecy must be produced in their entirety, without redactions. For all other redactions, please produce a log identifying each redaction and the asserted justification for it.

The Subcommittee will entertain proposals by Hutton for satisfying the Subcommittee's need for access to the Item 68 audit work papers which do not necessitate copying and production of all documents, the numbers of which the Subcommittee recognizes may be voluminous. All other documents for which the Company's claim of privilege or other protection has been denied shall be produced by 10 a.m. Friday, May 23, 1986. You are ordered and directed to produce these documents by that time. After that time, the procedures of 2 U.S.C. §192 will apply. No further delays of this matter will be countenanced.

Sincerely,

William J. Hughes
Chairman
Subcommittee on Crime

WJH:vsc

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WRITER'S DIRECT DIAL NUMBER

May
29th
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OUR FILE NUMBER
408,100-27

Hayden Gregory, Esq.
Counsel
Subcommittee on Crime
Committee on the Judiciary
207 Cannon House Office Building
Washington, D.C. 20515

Re: E.F. Hutton

Dear Mr. Gregory:

Enclosed pursuant to Chairman Hughes' recent letter to Mr. Rittereiser please find copies of documents 48 (as to contacts with banks), 63 and 78.

We have not enclosed copies of items 62, 103 or 126. As I discussed today with Ms. Sloan, (and as indicated in my letters of Dec. 8, 1985 and/or March 31, 1986) the privilege log does not fully disclose the nature of these documents, which are in fact privileged.

Item 62 comprises a cover letter dated Nov. 7, 1984 from T.F. Curnin to T.W. Rae, showing no copies to anyone. The enclosure is a memorandum to the file prepared by Mr. Curnin, reporting on a conversation between Mr. Curnin and Robert Fiske, a lawyer then representing George Ball. The memorandum does not, unlike the other Curnin file memos that have been produced, report a conversation with Mr. Murray; it reports a conversation between Mr. Curnin and Mr. Fiske, which related in part to a conversation Mr. Fiske had previously had with Mr. Murray. The conversation reported in the memorandum, between Mr. Fiske and Mr. Curnin, is clearly privileged, and of the sort that you and the Committee have previously recognized as privileged.

The documents numbered 103 and 126 are copies of the same document. The cover memo is dated Sept. 25, 1984; it is from Al Brower, Hutton's Deputy General Counsel, to T.F. Curnin, with copies to T. Rae and J. Tricarico at Hutton legal and T. Kavaler at Cahill. The enclosure is a memorandum, dated

Sept. 20, 1984, from Thomas Morley to Mr. Brower. Contrary to the description on the privilege log, neither document transmits notes of a telephone conversation with a representative of U.S. Trust Co., although Mr. Morley's memorandum of Sept. 20 does report to his lawyer Mr. Brower with respect to such a conversation. Once again, I think you will agree that these materials are clearly subject to the attorney-client privilege, and are the type of material that you and the Committee have recognized as privileged.

With respect to other matters, Hutton has determined it will produce versions of the documents previously produced, eliminating redactions based on grand jury secrecy. We will need until June 9 to do so, because Hutton feels the necessity to advise the affected grand jury witnesses in advance so that they may take whatever course they feel is appropriate. We will not, however, withhold a document merely because a witness has advised us of his desire that it not be produced. I trust this arrangement will be satisfactory to you. In this connection, I direct your attention to two cases apparently overlooked in the memorandum provided to Chairman Hughes -- the cases of Douglas Oil Co. v. Petrol Stops Northwest, 441 U.S. 211, 218 n.8 (1979) and State of Texas v. United States Steel Corp., 546 F.2d 626 (5th Cir. 1977), both of which hold clearly that witnesses have individual rights to the protection of grand jury secrecy, and have standing to assert those rights whether production is sought from the Government or a private party. See also State of Illinois v. Sarbaugh, 552 F.2d 768, 777 n.14 (7th Cir. 1977). We will also provide, on June 9, 1986, a log identifying the basis for remaining redactions; I can advise you now, however, that the only remaining basis for redaction will be the attorney client privilege.

With respect to the internal audit materials (items 67 and 68), the materials are in fact voluminous. As Ms. Baird and I told you in December, we are prepared to make them available to you on a convenient basis, and I would suggest you give me a call to discuss the logistics. So that you may have an idea of the volume, I am advised that the audit reports themselves (item 67) involve approximately 700 reports totalling 12,000 pages, while the work papers (item 68) comprise one redwell folder -- approximately 4-5 inches thick -- for each audit report. Although certain portions of the reports dealt generally with the subject of "cashiering," I am advised that non of the reports addresses the abusive cash management practices under investigation.

Please advise if I can provide any further information.

Very truly yours,

John F. Daum
of O'MELVENY & MYERS

cc: Virginia Sloan, Esq.